

# MEGA

## Moldova Economic Growth Analysis

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## Key Policy Messages

- In 2011 the Moldovan economy evolved, to a large extent, by inertia. It is true that in the first semester the economic growth was spectacular in terms of its magnitude and structure. However, the growth was uneven, with a low impact on employment and people's welfare. Moreover, the factors that spurred the economic growth in 2011 are expected to vanish soon, and the external dangers hover more and more threatening over the Moldovan economy. Thus, in the third quarter a clear trend of growth slowing settled into shape, and the uncertainty that will remain in the short- and medium run characteristic for the global economy and main trade partners of the country could affect significantly the capacity of Moldova to promote the desired model of growth based on investments, exports and innovations;
- We also remark that the strong economic growth of 2011 was accompanied by an exacerbation of the regional unbalances. Chisinau absorbs more and more financial, economic and human resources, widening the development gap with the other regions and worsening the regional development constraints. The transmission channels of the secondary wave of the financial crisis in Europe are of such a nature that it risk to widen even more the regional gaps in economic growths;
- The global economic perspectives will remain gloomy in the immediate future, especially in the Eurozone, where even an economic recession is possible. The resolution of the public debts problems in the EU will take time, which will have an economic and geopolitical impact on our region. The resources, time, political will and public support in the European Union will be used mainly to find solutions for the internal problems of the EU, the European Neighborhood Policy risking to go in the shadow. However, this should not make Moldova give up on its European perspectives. The main implications for Moldova are as follows: 1) the "success story" will need to be filled in with more content; and 2) the country needs development policies based on the expectation of a smaller volumes of external resources, on generation of higher internal revenues and on their more efficient use;
- The sovereign debt crisis will lead to important changes in the global economic and political system. To cope with their width and depth the smaller economies will need to develop clear adaptation plans. Unfortunately, we discover that the history of "national strategies" repeats itself. Failing to evaluate the impact of the 2008-2011 NDS, Moldova started the development of the new mid-term strategy paper "Moldova 2020". So far, the draft strategy seems very raw, with priorities selected somehow in a chaotic manner, without taking into account the internal economic realities and the capacity of Moldova to attain the set goals. While other documents, such as the budgetary-fiscal policy, are intensely debated in the Alliance for European Integration, "Moldova 2020" did not capture much of the politicians' attention. Is this an indicator of the low importance paid by politicians to this document? If yes, then we witness an exceptional political myopia;
- Moldova could also become a victim of the European financial vicissitudes. In particular, the sovereign debt crisis creates new risks for Moldova commercial banks. With the support from the National Bank of Moldova in 2011 they showed a remarkable progress in cleaning their balance sheets of doubtful assets and nonperforming loans. But because of the structure of bank portfolios and financial exposure of their debtors, the Moldovan banks are sensible to the European financial storms. If the debt crisis will eventually turn into a huge economic recession in the EU, the Moldovan banks will have to limit the crediting significantly, which could worsen the direct effects of the economic crisis over the Moldovan economy;
- The external crisis will also be reflected in the state budget. In 2011 the Government applied firmly a prudent budgetary policy and, as resulted from the draft budget for 2012, moderation will be on the agenda next year as well. The budgetary and fiscal policy proposed

for the next years are targeting the balancing and strengthening of the budgetary sources and at unifying and simplifying the fiscal system. But due to the conceptual flaws related to the development and approval of the budgetary and fiscal policy, and because of the ongoing political conflicts among the parties of the ruling coalition, it is difficult to have it approved. At the same time, even if approved, because of the external risks it will not ensure fiscal stability for many years and, most probably, will have to be reviewed in 2012. We believe that next year will be the moment of truth that will test if the adaptive model of the budgetary-fiscal policy is better than the inertial model;

- The never-ending disputes between the political parties trivialized definitely the word "reform". The need for "reforms" is invoked by the political forces on any suitable or unsuitable occasion, many times as an excuse for the created political gridlocks. Many external resources continue to enter the country to support the "reforms", creating, thus, a moral hazard for the governance. Therefore, when speaking about reforms in Moldova, we should start from acknowledging that most of the institutions that are needed for the operation of a market economy in Moldova were created but the main problem is that they are dysfunctional. Taking into account the developments in 2011, we believe Moldova needs the following reforms as a matter of priority: justice reform (including as a real precondition for reduction of corruption), decentralization, reform of the agricultural subvention policy, strengthening the internal and external control over public finance, reform of central public administration, which is expected to enhance the capacity of central authorities of absorbing and using soundly the public capital investments.

## Statistical Indicators

**Table 1. Moldova: key long-term economic and socio-economic indicators**

	2007	2008	2009	2010	2011 estimates
<b>Population, million (excludes Transnistria), beginning of the year</b>	3.581	3.573	3.568	3.564	3.559
<b>GDP, billion MDL, current prices</b>	53.430	62.840	60.429	71.849	83.854
<b>GDP, billion USD, current prices</b>	4.395	6.047	5.409	5.810	7.167
<b>GDP per capita, USD at PPP</b>	2715	2986	2843	3088	3370.0
<b>Real GDP, y-o-y % change</b>	3.0	7.2	-6.5	6.9	6.1
<b>GDP deflator, y-o-y % change</b>	15.9	9.7	2.0	11.2	10.0
<b>Private consumption, y-o-y % change</b>	3.6	4.5	-7.9	9.0	9.5-10.0
<b>Gross fixed capital formation, y-o-y % change</b>	25.5	2.2	-30.9	17.2	10.0
<b>Industrial production, y-o-y % change</b>	-1.3	0.7	-22.2	7.0	9.0
<b>Agricultural production, y-o-y % change</b>	-23.1	32.1	-9.9	7.9	3.0
<b>Share of industry in GDP, %</b>	19.1	13.9	13.0	13.2	13.6
<b>Share of agriculture in GDP, %</b>	10.0	8.8	8.5	11.9	12.0
<b>Merchandise FOB exports, million USD</b>	1373.3	1646.0	1331.6	1541.5	2160
<b>Merchandise CIF imports, million USD</b>	3676.4	4866.3	3275.8	3855.3	5000
<b>Service exports, million USD</b>	625.08	837.2	668.9	689.8	n.a.
<b>Service imports, million USD</b>	631.2	824.7	701.8	-770.1	n.a.
<b>Net foreign direct investment, million USD</b>	522.0	691.5	121.1	195.4	n.a.
<b>Net work remittances, million USD</b>	1419.4	1795.8	1124.4	1282.4	1410.6
<b>Current account/GDP, %</b>	-15.2	-16.7	-8.6	-9.0	n.a.
<b>Official reserve assets, end-year, million USD</b>	1333.7	1672.4	1480.3	1717.7	1980
<b>Total external debt stock, million USD</b>	3345.5	4093.8	4364.1	4778.7	5150
<b>External debt/GDP, %</b>	76.3	67.9	80.8	82.2	72.0
<b>External debt/exports of goods and services, %</b>	167.4	164.6	215.1	310.1	n.a.
<b>Employment rate, % of population aged above 15</b>	42.5	42.5	40.0	38.5	40.0
<b>Unemployment rate, % of economically active population</b>	5.1	4.0	6.4	7.4	6.7
<b>Real wage growth rate, y-o-y % change</b>	8.0	10.2	9.0	0.7	2.5
<b>Consumer prices index, year average on year average % change</b>	12.3	12.7	0.0	7.4	9.5
<b>General government balance, % of GDP</b>	-0.3	-1.0	-6.8	-2.5	-1.9
<b>General government expenditure, % of GDP</b>	41.8	41.6	45.3	40.8	38.4
<b>Exchange rate, year average, MDL per USD</b>	12.1	10.4	11.1	12.4	11.7
<b>Broad money (M2), y-o-y % change</b>	47.3	18.3	-3.8	18.3	10.0
<b>Central bank refinancing rate, end-year, %</b>	16.0	14.0	5.0	7.0	9.5
<b>Total commercial bank loans, % of GDP</b>	37.2	37.5	35.0	32.6	37.0
<b>Bank deposit rate, %, average per year</b>	15.1	18.1	14.7	7.6	8.0
<b>Bank lending rate, %, average per year</b>	18.9	21.0	20.3	16.3	14.0

Source: NBS, IMF, NBM and EXPERT-GRUP calculations, estimates and forecast;



## Summary

### Governance

The internal political climate, as well as the external context, continued to worsen during the past half of the year. But this does not eliminate the need for a strategic vision of the Government, which is reflected in the new draft of the National Development Strategy. The experience with strategic planning in Moldova revealed a series of drawbacks, including insufficient ownership, low capacity of strategic planning, implementation and evaluation, lack of continuity and even low quality of documents. The new draft strategy manages to overcome only a part of these gaps. Serious issues refer both to exogenous factors, such as budgeting of the implementation process and persistent dependence on the official development aid, political instability, central public administration not modernized yet, as well to factors related to the document itself, such as narrow approach and inappropriate treatment of overarching issues, incoherent priorities and total lack of the "strategy implementation" component. The short and medium-term perspective for the implementation of the strategy will remain volatile and rather negative. Thus, the document could be enhanced through a more comprehensive approach and proper risk evaluation.

### Business Climate

The advancement of the Republic of Moldova in the Doing Business 2012 ranking by 18 positions is a genuine record for our country. This places Moldova in the top-10 countries that registered significant improvements in three or more business areas measured by this rating. The establishment of bureau of credit history, which is expected to diminish the cost of credit, had a major contribution to this achievement. However, the Government seems to overestimate the importance of international ratings. Thus, according to the draft strategy "Moldova 2020", by the year 2020 Moldova should climb the business rankings and land among the first countries in the region. Although the intension of the Government is more than praiseworthy, some of the targets look rather unrealistically, contradictory, or worse, unnecessary. Actually, the Government should focus on some chronic problems, such as bringing up-to-date the competition legislation and proper regulation of the consumer protection.

### GDP

The economic growth in the first semester of 2011 was spectacular, both in terms of its magnitude and structure. With the 7.5% GDP growth, Moldova is in a better position than most other countries in the region. Moreover, at the first glance, it seems that the Moldovan economy is heading towards the much desired development model based on a higher contribution of the gross capital formation, stronger advance of exports than of imports, and the increasing share of Gross Value Added on the production side. But recent evolutions are explained by factors that will deplete soon. For example, the last year of the fiscal paradise finally brought the expected outcome - the investments increased, but probably not for long. By the end of 2011, we expect the economic growth to be supported stronger by final consumption, as investors seem to be already frightened by the crisis that is knocking at the doors. The evolutions for 2012 are uncertain and depend to a high extent on the settlement of the sovereign debt crisis in the euro area.

### Agriculture

In spite of the difficult weather conditions, in Q1-Q3'11 the agricultural production growth was positive, mainly determined by the crops sector. In the livestock sector, the continuous decrease in the production of milk is especially worrisome, putting at risk the related industries next year. The drought of August-November is a huge risk for the harvest of 2012, especially taking into account the shortage of quality seeds and prevalence of outdated agricultural technologies. However, given the crop structure and farmers' confidence, in 2012 the crops production is nonetheless expected to grow by 3.5-4%. The livestock sector will grow by about 7.7% (especially because of the recovery growth of milk and eggs production), which will determine an overall growth of agricultural

production by 5.1%. The reform of the agricultural subsidies policy remains a key priority for the long-term development of the sector.

### **Industry**

Although the growth dynamics of the industrial sector are encouraging, they are not sufficient for recovering the pre-crisis level. The growth of the mining industry slowed down slightly, but is still positive due to the high demand from the construction of engineering objects. Though the major industry - food and beverages - had a modest advance, the processing industry managed to maintain the growth rate over 11% due to the sector diversification through the re-launch of a number of smaller sub-sectors. Another positive trend is that the Gross Value Added per employee in most of the emerging sectors is above the processing industry average. As for the regional development perspective, there is a high concentration of the industry in Chisinau municipality, which is a clear signal that the regional development policies have not yielded yet any results.

### **Constructions**

The increase in the flows of remittances triggered the activity of construction companies during 2011. Thus, the volume of contracted works, share of the constructions sector in the GDP, and the prices for construction materials increased significantly. However, a sustainable re-launch of this sector is very unlikely due to a number of reasons: (i) it is not balanced, being explained mainly by the completion and commission of the projects started before the crisis, whereas the volume of new investments decreased; (ii) the image of construction companies in the eyes of banks and consumers was tarnished to a great extent. Therefore, the demand on the real estate market is still weak, and the prices for apartments have remained at the same level as they were before the bubble burst. Given the fact that the sector is close to its highest development potential, we do not expect a significant change of the situation next year.

### **Services**

The evolution of the service sector is uneven, with a higher growth of the services with lower value added. While the hotel services returned to the pre-crisis records, the performance of transportation services is lagging well behind the 2008 level. Statistical data suggest that the evolution of rail transportation services hinders severely the development of the sector. This is partly the result of the inefficient management of "Moldovan Railways" state-owned company, as revealed by an audit report of the Court of Accounts. This explains the slow recovery rates of the volume of transported goods.

### **Labour market**

The labour market recovery is still lagging behind economy's rhythm. There has been no clear recovery path so far, with fluctuating employment in the agricultural sector and even decreasing employment in construction. However, this year the Government gave greater importance to the development of the human capital in order to ease the entrance of young graduates on the labour market. Thus, "Studies: relevant for the career" is a priority of "Moldova 2020" Strategy. However, the draft strategy does not contain a clear vision on actions to be carried out and objectives to be achieved. Moreover, no analysis of the current situation was conducted prior to strategy development to identify the unbalances on the labour market. Another quite weird initiative, promoted by the State Chancellery is decreasing the informal employment. We see this as inappropriate because the task was assigned to the Ministry of Labour, Social Protection and Family, whereas the main stakeholder in this case should be the tax inspectorate, or even the entire system of public authorities as long as the issue at stake pertains to informal employment as a peculiarity of employment in agriculture and self-employment, not only as a form of tax evasion.

### **Households**

Despite rising average disposable income, a large share of the population does not earn yet enough to afford a decent living. This is true especially in the rural area, where the difference between the

disposable income per person and the cost of living is still negative and did not improve during the past year. This is fostered by the economic structure that does not offer economic opportunities to rural people, as well as by the social policy promoted by the Government. The latter is not focused on integrating the poor in the society and enhancing their opportunities to increase the revenues through access to education and health care, but rather on a functional approach, limiting itself to the calories a person should consume to survive biologically. However, those who managed to increase their income seem to support the economy through higher consumption. It is difficult to say what will happen in short-term, since the growth rate of both remittances and wages decreased sharply.

### **Prices**

Besides the augmentation of the people's disposable income - a traditional factor related to price rise during economic recovery - the inflationary processes in Moldova was determined by two rounds of adjustment in public utilities tariffs and the decrease of the domestic supply of fruits and vegetables. Additionally, the sharp increase in the exports of some agri-food products compressed the domestic supply, with a consequent adjustment in prices. However, according to our estimations, the impact of these inflationary shocks on the general price level seems to be a short-term effect. Therefore, once these factors disappear and the economic growth slows down, a moderate deflationary process is to be expected during the entire next year.

### **Monetary policy**

After the constant tightening of the monetary policy on the background of the dynamic recovery of the Moldovan economy, the National Bank of Moldova recently started to decrease the base rate and adjust its policy to the decreasing inflationary expectations for the next year. The change in the monetary policy stance was also motivated by the lower economic growth and more severe sense of insecurity of the global economy, caused by the sovereign debt crisis in the euro area. Therefore, the NBM maintains an inert policy, and in the next three months most probably it will continue to decrease the rates applied on the main monetary policy tools. The speed of the decrease will depend directly on the regional economic developments and dynamics of the deflationary process, expected in 2012 already.

### **Budgetary policy**

The growth of the national public budget revenues under the planned level forced the Government to amend the 2011 budget. On the background of a good economic growth and under the pressure of potential early elections this downward rectification is a proof of the firm governmental commitment to maintain the budget deficit under the planned level. The draft budget for 2012 confirms the Government's coherence in the promotion of a prudent budgetary policy with further decrease of the budget deficit under 1% of the GDP. In 2012 the corporate income tax will be reintroduced to balance the sources of budgetary revenues. At the same time, the budgetary-fiscal policy has a range of weaknesses, most of them stemming from the fact that the changes to the fiscal system were not based on a well defined and politically accepted concept.

### **Financial sector**

The economic recovery was fully reflected in the evolution of the banking system. Thus, the decrease of interest rate to new historic lows, coupled with higher consumption, fostered the demand for loans. As a result, the lending increased significantly, which enhanced the bank portfolios and profitability. At the same time, the augmentation of the households' disposable income, appreciation of the national currency and high insecurity regarding the external environment contributed to the increase in the volume of deposits coupled with a reduction of the share of bank liabilities in foreign currency. The local banking system is highly vulnerable to the eventual shocks in the external demand from EU, which is the main source of concern regarding the impact of the current sovereign debt crisis from the Euro area on the Moldovan banks.

**Foreign trade**

The foreign trade continued to extend during the second half of 2011 as well. The trade in goods advanced significantly the record levels of 2008, being supported by the trade in services. Though the statistical data reflect an apparently better situation, a series of worries cannot be overlooked. First, the comparative base will be less favourable by late 2011. Second, worsening of the external trade will slow down the trade expansion. Third, re-exports have an extremely important role in the current expansion of exports. But re-exports will be even more vulnerable to the decrease of external demand and, as a rule, are less associated with the economic development per se. These vulnerabilities of the foreign trade could exacerbate even more in the case of the strengthening of the negative trends of the regional and global economy.

**Global Markets**

Global economic prospects worsened significantly during the last half of the year. The situation is even more worrisome in case of advanced economies, especially in the euro area. In the euro area the problems are not limited to the need to repair the public and private financial system, but also include the restoration of the global competitiveness in the peripheral economies, revision of the social contract and even on the consolidation of the general European project. The situation of the global economy is reflected by the evolution on the global markets, where the descending and volatile trend of the prices for a number of goods has become quite pronounced. However, in spite of this, the prices are still high from a historic perspective. These evolutions should be taken into account by the Moldovan decision makers and should be reflected in the national development plans.

# 1. Governance

## To 2020 and back...

It is end of 2011 and Moldova is fast approaching its crunch time. On the paper many things still appear in rosy light, however both domestic and external environment are becoming increasingly unstable and unpredictable. Yet, all this does not deny the need for proper strategic thinking and vision. Indeed, how the country sees itself in the future, how it plans to use resources available, how it sees its reforms' plan and how it envisions to navigate the uncharted waters of the future to reach these goals is of paramount importance...and probably even more so in these turbulent times.

To be sure the history record of strategic planning in Moldova is patchy, at best. In the past a constant set of drawbacks impeded, to a varying degree, elaboration and, most of all, implementation of such documents. These drawbacks can be more or less grouped as follows: (1) issues of ownership, i.e. they were too often conceptually driven by donors as governments lacked will and/or capacity to elaborate the visionary and substantiated documents and thus remained rather fig leaves than guides for action; (2) governments were unable to properly plan and mobilize funds needed for implementation of strategies and remained overtly dependent on the donor support; (3) government lacked the capacity to bring these strategies to fruition as well as to ensure proper monitoring and evaluation of their implementation; (4) sometimes other governments (or personalities) inherited the strategies and, thus, were interested in drafting 'their own' strategies; (5) some of the documents produced were simply too weak from intellectual and conceptual standpoints.

These factors have determined to large extent lack of any substantial progress in implementation and evaluation of the previous NDS as well as mounting number and overlapping sector strategies, often adopted one after another without paying proper attention to the fact whether the previous one was implemented and if not, what constraints determined this outcome (see for instance suite of energy strategies).

Now, as the Government moves ahead with the new NDS2 (Moldova 2020), how much this strategic document will be immune to the vices that undermined implementation of the previous NDS and other strategic documents?

Firstly, there apparently is no doubt that the Government (or at least State Chancellery which is in charge with coordination of the documents elaboration) really owns it. One might even say, that it 'owns' it so much that is very reluctant to admit making meaningful amendments to its initial design. One thing here, another there, but overall the vision, pillars and structure of the document have remained intact throughout pretty lengthy period of consultative process.

Secondly, it still remains to be seen whether the Government will manage to mobilize the needed resources, however, it plans to tie it very much to the MTEF (and this is good) and it relies pretty much on the donor support (which is not very good, as Official Development Assistance may dwindle worldwide as financial crisis brings havoc to much of developed world).

Thirdly, the capacity of the government remains pretty limited. Despite the fact that coalition government tried to bring fresh blood to the public administration, and many young bright people joined it, the critical mass for change is still lacking and this may preclude proper implementation process of the new strategic document.

Fourthly, amidst permanent political instability and with early parliamentary elections looming large on the horizon, the continuity in the strategic thinking and commitment in the implementation process are no safe bet by any means. Curiously enough, Moldova 2020 has not become a part of the

inter-party debates, taking low profile against the backdrop of the lingering political instability and inability to reach the consensus on the electable presidential candidate.

The last but not the least, several question marks hang over the conceptual soundness of the strategy. Without going into much detail the frailties to be addressed are the following:

- The draft strategy is very much based on the “Constraints to growth analysis”<sup>1</sup>. The latter is a useful document but by no means is able to tackle comprehensively the “development”, which is broader than “economic growth”. This predicament leads to series of other shortcomings;
- However, even from the “economic growth” perspective it is hard to grasp why pension system is seen as a critical constraint to growth? This pillar so far appears as clear-cut outlier in the pack;
- Critically, the document fails to properly address series of critical cross-cutting issues. First of all, if European integration is a paramount goal of Moldova it should figure as such throughout the document. By the same token, such development issues as migration, gender, climate change, etc., should feature throughout various relevant parts of the Strategy;
- Even being a “visionary” document, the act that NDS2 lacks the implementation part is striking. It is critically important to know how the Government plans to achieve the objectives, even spelled out in general political terms. In its current form, the Strategy gives impression that the Government lacks any clear reform vision on achievement of the set goals;
- Finally, the Strategy authors appear to make an abstraction of the external context. The strategy is pretty static, failing to grasp the external dynamics (such as looming global economic crisis) and implications of such global and regional trends as climate change, migration and so forth. As the strategy will not be implemented in temporal and spatial vacuum, it is necessary to make the strategy more “dynamic” in its approach to development.

## Forecast

- The short-term perspective for the country has worsened. As attempts to identify an electable candidate for the country’s supreme post have repeatedly fail the political instability has become a permanent feature for Moldova. As early election will not necessarily break the deadlock the perspectives for reform may turn truly grim. And this does not bode well for the implementation of Moldova 2020 either. As current institutional near-paralysis shows, the reforms and strategic thinking are put to the back banner while the politicking reigns;
- The external environment is apparently set to deteriorate as well. The sovereign debt crisis has brought havoc to the Euro area, and may well shake even the political foundation of the European project. The perpetuation of the euro crisis, if accompanied by political ramifications, may put the brake pedal or stall altogether the bigger European initiatives in its neighbourhood as the core EU states will become increasingly introvert;
- Against this background, Russian incursions in the western CIS will perhaps amplify, at least in the short-term. The public mood in Moldova has already turned a bit sore on the issue of the European integration, and the protracted crisis of the current pro-European ruling coalition coupled with depressed situation in the EU can revive the old geopolitical dilemma: East vs. West;

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<sup>1</sup> Alex Oprunenco, Ana Popa "Report on analysis of constraints to economic growth", The Government of the Republic of Moldova, 2010

- Furthermore, the global economic outlook has been becoming gloomier by the day. It is needless to say that the second wave of the global economic crisis would afflict much damage upon Moldova, and may make the visions set in Moldova 2020 grotesquely outlandish.

### Policy recommendations

- As mentioned the development environment has become increasingly shaky, and as much as Moldova 2020 is concerned the risk assessment would solidify perspectives for successful implementation of the strategy. Overall, the Government should consider prolonging the consultation process in order to address the most critical shortcoming of the new NDS;
- The 2009-2010 post-crisis experience should be re-analysed in order to ensure the country is better prepared for the new shock if it arrives;
- With the current political class it makes little sense to insist on political consensus and national interest. The situation may become even worse as domestic political landscape becomes increasingly fragmented (Party of Regions and “Dodon” group...so far). It is clear that Moldovan politics needs a reset...it is still an open question how to find out where the button is?

## 2. Business Climate

### Looking beyond business rankings

The legislation that currently controls the competition in Moldova can no longer handle the challenges posed by the local market. Two years ago the National Agency for the Protection of Competition (NAPC) started working on a new version of the law on competition and the law on state aid. With a considerable delay the first drafts of these two normative acts became available to the business community in August 2011. The draft provisions assign NAPC a wide range of rights that under certain circumstances might have a questionable impact on the business community. For instance the law imposes exaggerated fines. In addition some activities that do not directly affect competition are automatically deemed unlawful without consideration of the circumstances. Thus, despite the assistance received from the international experts NAPC failed to deliver a well balanced package of regulatory measures. Should the draft be approved in the current form, the new law will be unable to ensure a healthy competition without being too uptight (for more details see [Short Analytical Note Nr. 68](#)).

Consumers' rights emerged again as a pressing issue. The reduced level of trust local consumers display towards the goods and services available on the local market also puts some pressure on the business climate. The recent inspection of a wholesale food warehouse performed by the employees of the Ministry of Internal Affairs once again brought up the issue of consumer's rights. The public authority currently responsible for protecting the consumers in Moldova is the State Inspectorate for the Market Surveillance, Metrology and Consumer's Protection (SISCP)<sup>2</sup>. Unfortunately the legal provisions that sustain the activity of the SISCP proved to be inefficient in a number of ways. For instance, according to the legal provisions in force companies must be notified in advance about the scheduled inspections. Moreover, the penalties applied in respect of counterfeit products or extended shelf life are way too small to prevent further illegal practice of that kind. Obviously, the customers are not the only victims in this situation. The sellers/producers of genuine products experience lower sales and loss of reputation. Under these circumstances it is necessary to ensure an upgraded regulatory endorsement that protects both the consumers and the enterprises.

According to the latest business rankings recently published by the World Bank, Moldova moved 18 positions up in the list. This improvement also places Moldova top 10 world economies that managed to register some improvement in three or more business areas measured by this ranking.<sup>3</sup> More specifically the publication states that Moldova has: eased the process of starting a business; upgraded the insolvency regulation; facilitated the procedure of enforcing contracts and last but definitely not least, Moldova improved its credit information system by establishing its first bureau of credit history. The bureau will ensure a gradual reduction of the risk margins charged by banks on loans. The institution began its activity in April 2011 and is already cooperating with 15 commercial banks. This was actually the sole reason behind Moldova's most recent evolution in the "access to credit" sub-ranking – currently Moldova occupies the 40<sup>th</sup> place, 49 positions higher compared to the 2011 edition of Doing Business.

The above depicted tendencies are somehow offset by the opposite movement registered in the latest publication of the "Doing Business" fiscal ranking. Overall Moldova dropped three positions since 2011<sup>4</sup> and currently is placed the 109<sup>th</sup> place in the global ranking. The number of tax payments

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<sup>2</sup> The official regulation of SISCP explicitly states that the institution has to supervise the market and verify the goods that go onto the market shelf. Government decision Nr. 757 / 27.06.2008 "Regarding the State Inspectorate for the Market Surveillance, Metrology and Consumer's Protection"

<sup>3</sup> <http://www.doingbusiness.org/reports/global-reports/doing-business-2012>

<sup>4</sup> <http://www.doingbusiness.org/~media/FPDKM/Doing%20Business/Documents/Special-Reports/Paying-Taxes-2011.pdf>



performed by an average company during the course of a year has remained constant, however, Moldova's position in the ranking has dropped slightly due to improvements registered by other states (Moldova moved from 152<sup>nd</sup> position to 158<sup>th</sup>). As for the number of hours necessary for complying with all the tax regulations – this indicator increased from 95 hours in 2010 to 98 hours in 2011.

Moving from 2011 to 2020 it's necessary to mention the far reaching goals set by the draft National Development Strategy Moldova 2020 - an official document that aims to set development objectives for the next decade. According to the plans of the Government, until 2020 Moldova should climb the business rankings and land among the first countries in the region. The priority directions of the Government concern: the time necessary for complying with all the tax regulations, the time necessary for obtaining a business registration certificate, increased return on investments made in Moldova, etc. Although the intension of the Government is more than plausible, some of the objectives look rather unrealistically, or worse, unnecessary. For instance, the Strategy states that by 2020 the average number of state inspections performed at a company's premises should decrease by 40%. Of course, such measures might actually bring Moldova a few positions up in the ranking, but is the game worth the candles? And most importantly, are such goals consistent with other short term objectives? It's rather obvious that the new Law on competition will add up to the number of state inspections. The forgery cases and other illegal practices covered earlier in this chapter also call for action (i.e. more inspections), the Governmental action plan to fight informal payment of wages is closely linked to inspections. In addition, the new VAT reclaiming options that will come in force as of January 2012 are likely to increase the average frequency of inspection (for more detail please see [Short Analytical Note Nr. 63](#)).

## Forecast

- Given the complexity of the document and the necessity to issue some complementary normative acts it is highly unlikely for the entire legislative package on competition and state aid to be approved any time soon. Should NAPC revise the draft published in August, and readjust the regulatory deficiencies of the Law, the complete provisions will become applicable by the end of 2012- beginning of 2013;
- Once the 0% tax rate will be eliminated in 2012 the amount of reinvested income should cease among companies operating on the Moldovan market. The reintroduction of the tax is unlikely to cause any substantial decrease in the volume of Foreign Direct Investments, nevertheless such a scenario is still possible should a second wave of crisis occur. Usually, fiscal provisions are just one of the factors (and definitely not the main one) potential investors consider before launching a business in a certain country. Infrastructure, administrative burden, transparent regulatory systems, skilled workforce have a much more significant impact on investor's decision.<sup>5</sup>

## Policy recommendations

- NAPC should accelerate the pace of work on the new Law governing competition and the law on state aid. Of course, any further actions should not be taken at the expense of quality, yet after nearly two years it is time for NAPC to deliver a well structured document able to handle the new market challenges. A special emphasis should be placed upon the legal charges and the list of illicit behaviour (from a fair competition standpoint);
- In the light of the increasing forgery cases it is necessary to revise the law package regulating the inspections of food stocks undertaken by responsible institutions. More specifically it is necessary to eliminate the provision according to which companies are notified in advance about the upcoming inspection of the stock;

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<sup>5</sup> Vito Tanzi, Howell Zee, "Tax policy in developing countries", <http://www.imf.org/external/pubs/ft/issues/issues27/index.htm>

- The Government should revise the business climate priorities listed in the National Development Strategy of Moldova. Most importantly it is necessary to coordinate the short term objectives with the long term strategy. In that regard, the authors of the documents should cooperate more closely with the public authorities responsible for the implementation of the plan;
- Too much emphasis on the business rankings might actually backfire in the long run. The goal recently set by the Ministry of Economy and Commerce might prove to be unreachable in case the necessity for inspections of all kind increases. Under such circumstances it is advisable to implement the practice of combined inspections, performed by several authorities at the same time, so that to avoid endless timeframes of inspections. Of course, in order to simplify the procedure and diminish the timeframe the inspections should be somehow correlated based on the main subject or set of verified documents.

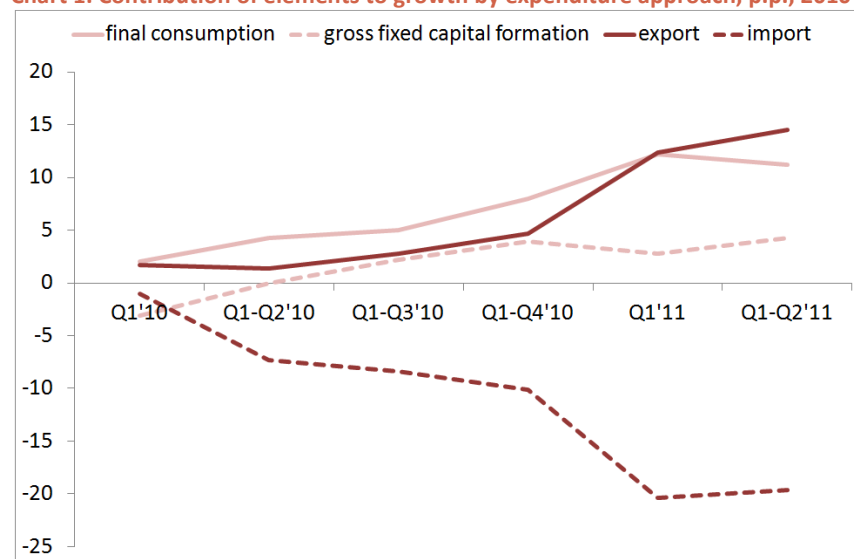
### 3. Gross Domestic Product

#### Economy's arrhythmia

The economic evolution in the first semester 2011 was favorable for Moldova. The GDP growth of 7.5% in this period was impressive by any comparison: Central, South-Eastern or Eastern European countries. Despite the slight slowdown of the growth in Q2'11, the first impression on the data is positive and makes many observers see the "long-awaited mirage". For the first time in many years, we have an almost perfect structure of growth with high contribution of investments to the economic advance, exports rising almost twice faster than imports and gross value-added (GVA) positive change suppressing the share of net taxes on goods and imports.

With rose-colored glasses off, the view is slightly different. Final consumption is still the main growth factor, with 11.2% contribution to growth (Chart 1). The increase in gross fixed capital formation, indisputably important, has been supported by few factors. Changing priorities of the government and higher investment in infrastructure has definitely contributed to the growth. Additionally, the last year of "fiscal paradise" seems to finally reach its goal to increase private investment. Both data on long-term tangible assets and FDI point to this conclusion. Thus, while FDI in equity capital rose by 46.6% in H1'11 y-o-y, the reinvested profits rose 8.5 times during this period - an all-time record since the introduction of zero corporate tax rate for reinvested profits in January 2008. Also, the long-term investments in tangible assets experienced an important advance mainly due to procurement of equipment and machinery. At the same time, the positive change of inventories of non-assembled equipment (by 46.8% in Q2'11 and by 30.2% in H1'11) leads us to the conclusion that companies wish to avoid next year taxation, by investing in advance. However, this factor will run short by the end of the year and we can already see a slowdown in Q3'11. It is explained by the worrying external economic situation and internal perspectives that are much more important for future investments than some short-term amenities.

**Chart 1. Contribution of elements to growth by expenditure approach, p.p., 2010-2011**



Source: NBS;

The spectacular rise in exports was strongly supported by re-export, not a negative fact per-se, but contributing less to the GVA and to employment. The re-export represented 47.1% of total exports in Q1-Q3'11, explaining 31.2% of the total growth. Thus, it is clear now why the "trade miracle" has not

been accompanied by proportional growth in industrial sector. Meanwhile, imports advance due to still rising consumption and goods entering the country for re-export.

The changes on the production side of GDP provide a positive outlook with a more diversified growth. Certainly, this year not only services provided the basis for the growth, but this is also a side of recovery process, the economy moving towards the pre-crisis structure. Industrial sector, and especially mining and quarrying, and construction advanced significantly. Thus, despite lower demand for real estate, works in infrastructure backed up the construction sector and related industries.

Thus, the GDP growth in 2011 was over previous expectations, and both the Government and IMF revised in the third quarter their forecasts in the positive direction, to 6.5% and 7% respectively. But further growth perspectives are not so bright. Global economic threats are more discernable, with slow recovery of the US economy, sovereign debt problems in EU and low performance of financial sector in Russia. No surprise, the last IMF World Economic Outlook came with new, more pessimistic forecast for most of the countries, including Moldova, due to its dependence on remittances from abroad and obviously expected decline in exports to these countries (Table 2).

**Table 2. GDP growth forecast by IMF in some countries, % growth, y-o-y, 2011-2012**

Country	2011		2012	
	April, 2011	September, 2011	April, 2011	September, 2011
<b>Germany</b>	2.54	2.73	2.09	1.27
<b>Greece</b>	-3.04	-5.00	1.08	-2.00
<b>Italy</b>	1.52	0.64	1.30	0.32
<b>Portugal</b>	-1.51	-2.16	-0.48	-1.84
<b>Romania</b>	1.47	1.49	4.36	3.49
<b>Russia</b>	4.83	4.29	4.50	4.08
<b>Spain</b>	0.83	0.78	1.60	1.12
<b>Ukraine</b>	4.50	4.70	4.90	4.80
<b>Moldova</b>	<b>4.50</b>	<b>7.00</b>	<b>4.80</b>	<b>4.50</b>

Source: World Economic Outlook, IMF;

The NBM was the first to express its concern about the current global economic situation and the risks it poses for Moldova. NBM already anticipates the cooling down of consumption and inflationary pressures in 2012 as a result of sovereign debt problem in Eurozone and the instability of main international currencies. Thus, the monetary policy will aim to support business activity and consumption next year and the first steps towards loosening the monetary policy have been already done. Meanwhile, Ministry of Economy also updated the forecast based on the expected evolutions in the main trade partners and host countries for Moldovan emigrants.

## Forecast

- By the end of this year Moldovan economy will continue its strong pick-up, with expected 6.1% GDP growth for 2011. Final consumption will keep its position of main determinant of growth, with an expected increase up to 10%. We have revised our previous forecast for the gross fixed capital formation evolution. Even though the last year of zero corporate income tax had the potential to stimulate investments, and did so in the first half of the year, the external economic threats are way more important for the investors;
- The economic growth will slow down in 2012 with the forth-coming crisis in Europe. While in regular conditions we would have expected a 5.6% GDP growth rate, the further evolution of the situation on the external markets and the way it is going to be solved will determine the

magnitude of the impact on the Republic of Moldova. We should take into account even a worse scenario than 4.5% growth predicted by IMF or 4% by the Ministry of Economy.

### **Policy recommendations:**

- A real challenge for the Government next year might be the financial ability to support public investment in a possible scenario of decrease in budgetary revenues. Nevertheless, this should remain a mid-term priority, with further increase in investments in infrastructure;
- Promotion of a competitive and innovative economy should be a national goal. The draft Innovation Strategy is a first step towards its achievement, however, weak and incomplete. The Government should create the necessary framework for active research and development activities in any type of institutions: universities, business sector, state institutes, NGO's.

## 4. Agriculture

### Expected trends, unexpected policy initiatives

In Q1-Q3'11 the agricultural sector displayed an evolution that seems quite comforting for the policymakers: the overall agricultural output increased more than 3.7%, mainly due to the crops production (+4.4%) which went slightly ahead of the long-term trend. The livestock subsector remained on positive path as well, however, the growth was two times slower (+2.3%) and it has also been slightly below the historical trends. The yields have improved for a number of high-value crops, such as grapes (+82%), potatoes (+29%), seed cereals (+18%) and open-field vegetables (+32%). The wheat harvest significantly exceeds the previous year performance, for both quality and quantity. At the same time, yields have significantly declined in case of other high-value crops, with soya, sugar beet and some fruits losing one quarter of the previous year indicators. In case of the livestock production, two of our predictions turned true: the production of meat continued its strong growth (+7.4%) on the account of pork and poultry production, while the difficult situation of the milk producers worsened, with milk production declining 7%.

Many factors influencing the agriculture evolution in 2011 are related to the poor weather conditions: in the period from August to November 2011 almost half of the country's territory was featured by deficit of precipitations and soil humidity depleting reserves. As of early December, the situation worsened further. This represents a very significant risk for the 2012 harvest, especially considering the shortage of high quality seeds and prevalent use of traditional (non-conservative) agricultural techniques in the small agricultural entities. At the same time, the available evidence suggests that in 2011 many farms (especially mid- and large-size) that made efforts to modernize technologically were able to avert the disastrous effects of the drought.

An interesting policy document has captured our attention recently: the Strategic Priorities for the Activities of the Ministry of Agriculture and Food Industry in 2011-2015 (part of which is the Food Safety Strategy<sup>6</sup>). The document links the development of the agricultural policies with the broader policy of European integration and clearly sets out the need for changes for the Moldovan agriculture to remain competitive on both domestic and European markets. It identifies priorities that the MAFI is going to embark upon in the next three years (Table 3). We have advised many of these priorities in previous editions of MEGA (such as food safety, reform of the R&D and training sector, and reform of the subsidies policy). However, the document does not provide an easy reading, as it is quite heterogeneous and the quality of analysis, depth of strategic thinking and structure of planning differs greatly across the ten priority areas.

**Table 3. Key priorities and measures envisaged by the MAFI for the period 2011-2014**

Priority areas	Key measure envisaged
<b>Reform of the food safety policy;</b>	Create the National Agency for Food Safety; Create border food safety check-points; Classify and monitor the national producers based on food safety risks criteria;
<b>Restructuring and modernization of the vine and winemaking sector;</b>	Approve primary and secondary legislation for implementation of the Protected Geographical Indication and Protected Designation of Origin; Create the public-private Agency for Wine Promotion; Efficiently use the 75 million Euro loan provided by the EBRD;

<sup>6</sup> Approved separately by Governmental Decision no. 747 of October 3, 2011.

<b>Support for the development of a modern market infrastructure;</b>	Build a wholesale agricultural marketplace near the Chisinau municipality;
<b>Implementation of conservative agriculture;</b>	Create the monitoring soils quality information system; Stop active forms of soils degradation and apply conservation and fertilization measures on 1.7 million ha. Promote low-scale irrigation, biomass and no-till agricultural technologies;
<b>Reform of the meat and milk production;</b>	No clear measure defined.
<b>Support to the production of renewable energy based on agricultural waste;</b>	Develop and improve legislative framework on the biomass; Consolidate relevant scientific, technical, and economic resources; Elaborate tools to estimate the real potential for the biomass; Create conditions for the economic use of the biomass; Train specialists in biomass and raise public awareness;
<b>Reorganization of the existing research and training resources;</b>	No clear measures defined;
<b>Reorganization of the agricultural subsidies policies, aiming at modernization and concentration of production;</b>	No clear measures defined;
<b>Implementation of informational systems for streamlining the supply chains;</b>	Create a comprehensive Animal Traceability Information System; Create an Integrate Information System for the Management of the Phytosanitary Authority;
<b>Support provided to the high-value agriculture</b>	Create agricultural products marketing centers; Maintain existing markets for small producers, while consolidating food safety and fiscal control; Organize regional wholesale marketplaces; Develop market infrastructure at central level;

Source: summary by EXPERT-GRUP;

Some of the priorities are long awaited, such as in case of the food safety strategy. Achieving the goals under this priority will require breaking the vested interests thriving on current institutional setup. However, identification of correct priorities is by no means a guarantee of proper implementation approach. We believe that interventions that MAFI plans for some of these priorities may in fact hinder the sector's development. For instance, the MAFI is looking forward to create an agricultural hypermarket near the Chisinau municipality. Instead of offering the farmers gateway to the market, this initiative can strengthen even more the intermediary agents taking over the biggest proportion of the created value-added.

## Forecast

- Based on the evolutions in Q1-Q3'11, we expect a 3.0% growth in total agricultural output for 2011. Because of the severe drought affecting more than half of the Moldova's territory, forecasts of the agricultural production for the year 2012 are highly uncertain at this

moment. However, the year 2011 has been similar by its agro-climatic characteristics to the year 2008. Considering the structure of planted areas, we expect that the overall crops production will grow by about 3.5-4% in 2012. The production of animal products will grow by 7.7% (mainly due to milk and eggs production), with total agricultural product likely to register a 5.1% growth;

- This outlook correlates with the positive balance of expectations farmers have for the next 12 months<sup>7</sup>: 22.5% of the farmers believe that economic situation of their sector will improve, while 15.3% - will worsen. Almost half of the farmers expect that next year the agricultural prices will grow, but the perspectives of income are not clear, as 80% of the farmers believe that their production costs will grow as well.

## Policy recommendations

- Aside from the information systems envisaged by the MAFI that are needed to ensure proper control and management of the agricultural sector, it is also highly necessary to improve the agricultural statistics system, starting from introducing new indicators to upgraded collection system. This would also allow the MAFI to adopt more evidence-based policies;
- Despite the difficult weather conditions in 2011, there is evidence of many small to mid-size Moldovan farms successfully overcoming this situation. It is therefore highly necessary to encourage the transfer of positive experience and best practices from the more advanced Moldovan farmers to the others and here a partnership between the MAFI and farmers' associations would play a key role;
- As envisaged by the Strategic Priorities document, MAFI expects that foreign resources (loans, grants, technical assistance) will remain for the years to come a defining factor of the Moldovan agriculture. In this context it is necessary to ensure full transparency in the use of resources. At the same time, the foreign support will not last forever. This will require amendments to the agricultural subsidies policy, so that the policy gives priority to capital investment and provides for a more efficient risk sharing with the beneficiaries.

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<sup>7</sup> According to Business Confidence Survey conducted by EXPERT-GRUP in November 2011. Business Confidence Index may vary within the interval [-1;1].

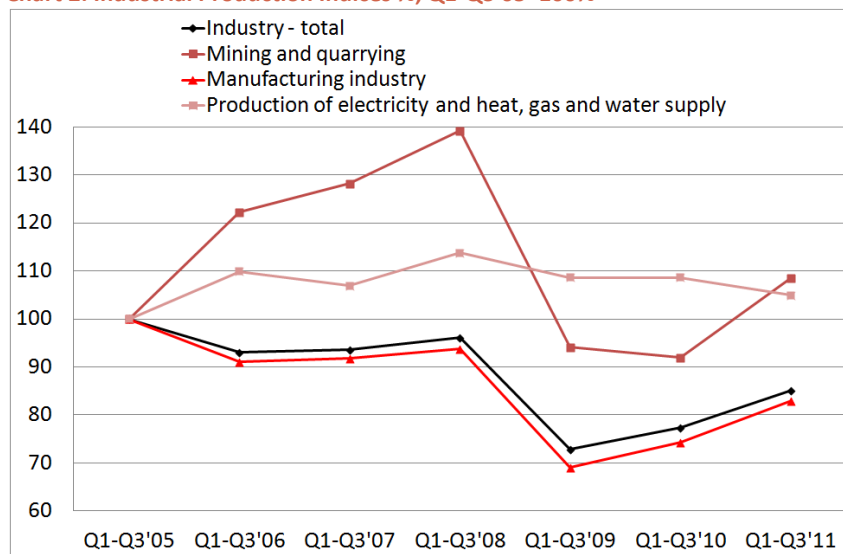


## 5. Industry

### Awaiting the full recovery

The positive evolution of the industrial sector registered in Q1'11 was maintained in the subsequent quarters, thus during the first 9 months of the year the sector registered an overall y-o-y growth rate of 10%. As mentioned in the previous issues of [MEGA](#), although the growth dynamics are encouraging, they are not sufficient for achieving the pre-crisis level (Chart 2). Should a similar growth rate persist during the next periods, the performance registered in 2008 will be exceeded only by 2013.

**Chart 2. Industrial Production Indices %, Q1-Q3'05=100%**



Source: NBS and EXPERT-GRUP calculations;

Compared to Q1'11 in Q1-Q3'11 the growth rate of the mining industry slowed down, reaching 18.1%. This moderate increase was determined by the demand for repair and maintenance works, in particular for infrastructure projects. Given the government's intentions to increase the next year's expenses for public infrastructure, the perspectives of the sector remain optimistic.

The processing industry that currently holds the largest share in the industrial sector (about 85%) also registered a lower growth rate (reaching 11.7% y-o-y during Q1-Q3'11, 0.9 p.p. lower than that registered in Q1'11). However, the evolution registered across different subsectors allows for a positive outlook that the performance will be maintained until end of 2011.

The 2008-2009 crisis had a negative impact on nearly all the processing industry sectors. However, for some of these sectors the recession had a short-term impact that was quickly followed by a pronounced recovering trend; whereas for others the impact was both longer and more profound. Of the four industries that have exceeded the level of 2008, only two sectors (*chemical industry*, *garment industry*) registered negative growth rates after the crisis, whereas for the other two sectors (*production of tobacco products*, *production of machines and electric devices*) only the growth rate slowed down. But in many industries the crisis left deeper traces and at least one year will be needed to overcome the consequences. Several sectors call for increased attention, as they face chronic problems that the crisis only exacerbated. Among these there are the "*wood processing and production of wood products*" and "*production of rubber products and plastic materials*", which do not show any signs of recovery. It is possible that these sectors are going through a deeper restructuring. A more detailed sector analyses is necessary to overcome the eventual input-related

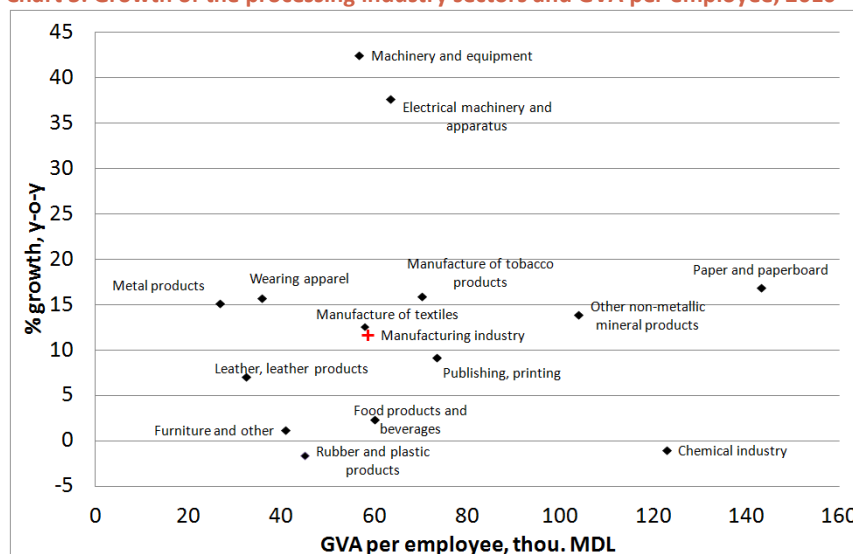
constraints. At the same time, because some outputs of these sectors are intended for the construction sector, the slow recovery of constructions will also limit their growth.

The most important industry of the country, "*food and beverage production*" is also in the category of slowly recovering sectors, as well as the "*paper and cardboard*", which depends a lot on the former. After the government took specific actions to open foreign markets for this sector and after gaining some success in that regard, it is rather obvious that the limitations are supply-driven. Of course, to some extent the troubled recovery is related to the bad weather conditions registered during the current year. In that regards it is appropriate to mention the *canning and fruit processing* industries. The main problem is related to the limited ability of this sector to adjust itself to the market requirements, thus putting at risk not only the possibility to enter new markets, but also the possibility to maintain the old ones.

Thus, during Q1-Q3'11 the growth of "*food and beverage production*" slowed down (with a growth rate of 2.3% y-o-y only) and the growth of other processing industry sub-sectors exceeded average rates significantly, leading to a slight change of the industrial structure. Given the fact that the food and beverage industry has a share of about 47%, and the growth above the average rate was mainly registered in the sectors with the share under 3.5%, we detect a positive trend of industry diversification. The most spectacular growth occurred in the following industries: "*manufacture of machinery and equipment*" (42.5), "*production of machines and electric devices*" (37.7%), "*manufacture of medical, precision and optical instruments*" (43%).

To make a quality appraisal of the processing industry's development during the analyzed period we used the Gross Value Added (GVA) per employee recorded by sectors of this industry in 2010<sup>8</sup>. Thus, if we take into account the fact that the GVA per employee in the *food and beverage industry* is slightly over the average, we may conclude that sectors with stronger growth did not change significantly the structure of the processing industry in terms of GVA per employee (Chart 3). However, the sectors with above-average growth are predominantly those with the GVA per employee exceeding the average in question.

**Chart 3. Growth of the processing industry sectors and GVA per employee, 2010**



Note: The chart presents only the industries for which GVA was calculated in the Structural Survey in Enterprises, 2011;  
Source: NBS and EXPERT-GRUP calculations;

<sup>8</sup> According to the results of the Structural Survey in Enterprises, NBS, 2011

The energy sector had a relatively stable evolution throughout the entire Q2-Q3'11, reaching 96.6% y-o-y. In Q1-Q3 the consumption of electricity in the country increased by 3.6%, but it was covered by imports, whereas the internal production decreased by about 2.6%. The rise in the price for gas by 23% on average (since 2011) will reduce further the production of the sector.

In Q1-Q3'11 the Chisinau municipality increased the volume of industrial output by 5.1% y-o-y rising its share in total industrial production to 63.1%. This growth was gained on the account of all other regions except Gagauzia; however the Northern region lost the most in its share (3.8 p.p.). Therefore, the efforts to promote regional development of the country has not yielded the expected results yet. This is reflected by the Business Confidence Index<sup>9</sup>, which reveals a much lower economic confidence (almost twice lower) in regions (except for Gagauzia, that actually has the highest index) than in Chisinau municipality. The overall business economic confidence index in the industrial sector is 0.043 which, though not very high, is not as negative as in agriculture and construction sectors. Another promising fact is the medium expectations of industrial companies regarding the increase of sales and employment. As for the development of production factors and access to credit, the industrial companies have negative expectations, though better than in other sectors.

## Forecast

- Taking into account the recent results of the industrial sector, we expect that it will grow by 9.0% in 2011. Though the published data do not show any diminution of exports, the risk remains relevant for the current year and the entire 2012. As a consequence, for 2012 we expect a decrease in the industrial growth and an overall performance of app. 6%;
- The quarrying and mining industry will maintain its growth rate at the current level and is expected to finish 2011 with a 16% annual growth mainly due to the demand from the public sector and repair works in the residential sector. A growth of 15% is expected for next year mainly due to the higher investments in the public infrastructure;
- Taking into account the positive evolution of the processing industry and the risk of decline in the demand for exports, this industry is expected to register an annual growth of about 11%. At the same time, in 2012 it will be within the limits of 7%;
- The energy sector remains on the negative slope and is expected to decrease by 6% in 2011 and by 4% in 2012.

## Policy recommendations

- The global crisis influenced almost all industrial sectors, but the impact varied widely among subsectors. While the crisis acted as a temporary shock in some sectors, in others it worsened the already difficult pre-crisis situation. The latter group encompasses, among others, the "wood processing and production of wood products" and "production of rubber products and plastic materials". Some subsectors of the above mentioned groups have a relatively good evolution, but it is necessary to monitor in-depth the problematic sub-sectors to eliminate the eventual limitations related to access to resources, market or related to regulations and conditions specific for these sectors;
- The further industrial concentration in Chisinau municipality is a clear signal that thus far the regional development policies have not yielded any results. Therefore it is necessary to promote more assertively the establishment of new industrial poles and apply appropriate incentives for the development of industrial enterprises in regions. As the lack of skilled labor force is one of the main constraints in regions, "hunting" for large investors might not yield the expected results. Use of local resources and import substitution are the main directions

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<sup>9</sup> According to the Business Confidence Survey, conducted by EXPERT-GRUP in November 2011

to follow. Developing the industry in regions should become one of the main regional development policies that should be based on the regions' competitive advantages.

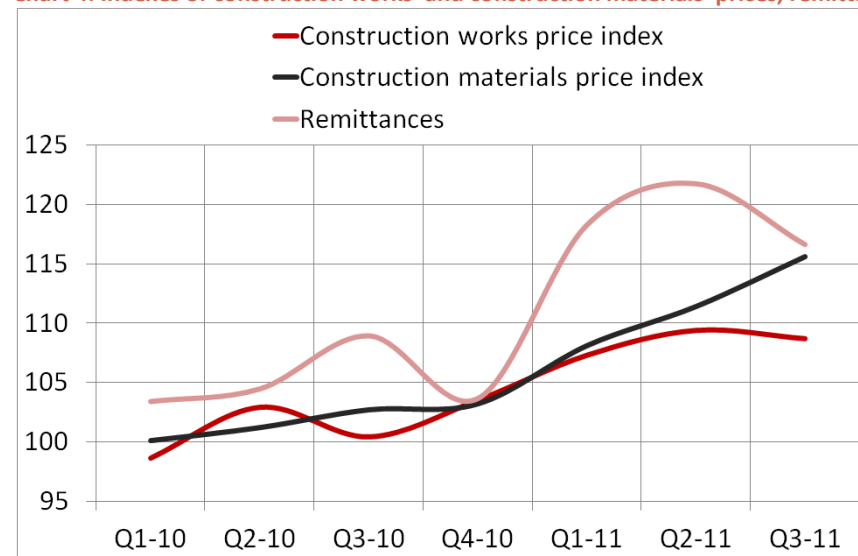
## 6. Constructions

### Bearing the consequences of a burst bubble

The overall economic recovery and resurging remittances “greased the wheels” of the real-sector over the 2011 year. Thus, the construction firms enjoyed more cash flows, partially solving the liquidity shortage which kept them blocked during the crisis. Generally, the sector followed a very unbalanced recovery path, as the real-estate companies suffered a significant confidence loss, while the economic and political situation remained uncertain.

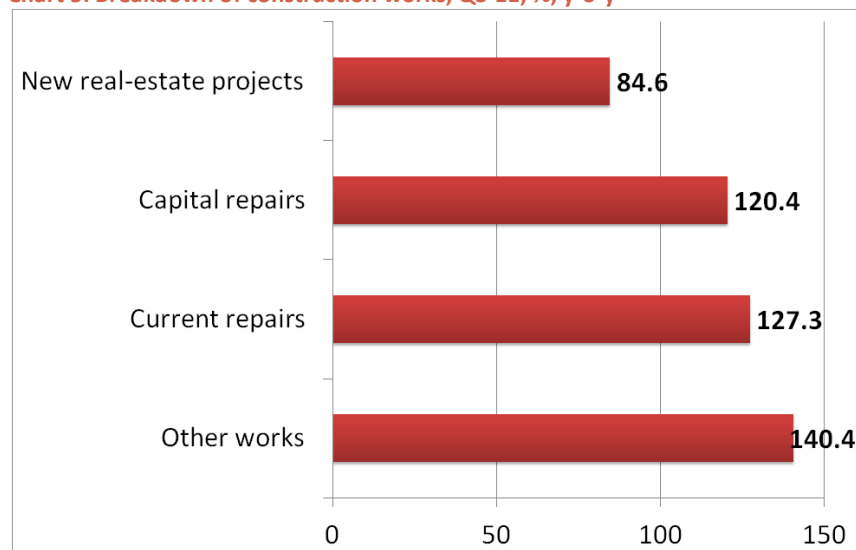
Thus, on the upside, during the three quarters of the current year, the amount of capital projects, current repairs and other works grew by 20.4%, 27.3% and 40.4%, respectively, in y-o-y terms. Consequently, it gave a fillip to the price index of construction works (+8.7%), with the highest contribution from the real-estate sector (+11.8%), as well as to construction materials price index (+15.6%) (Chart 4). Additionally, the value of finished buildings increased by 45.6%, while the sector’s share in GDP increased from 3.4% to 3.8% after the H1’11 in comparison with the previous year.

**Chart 4. Indexes of construction works’ and construction materials’ prices, remittances, %, y-o-y**



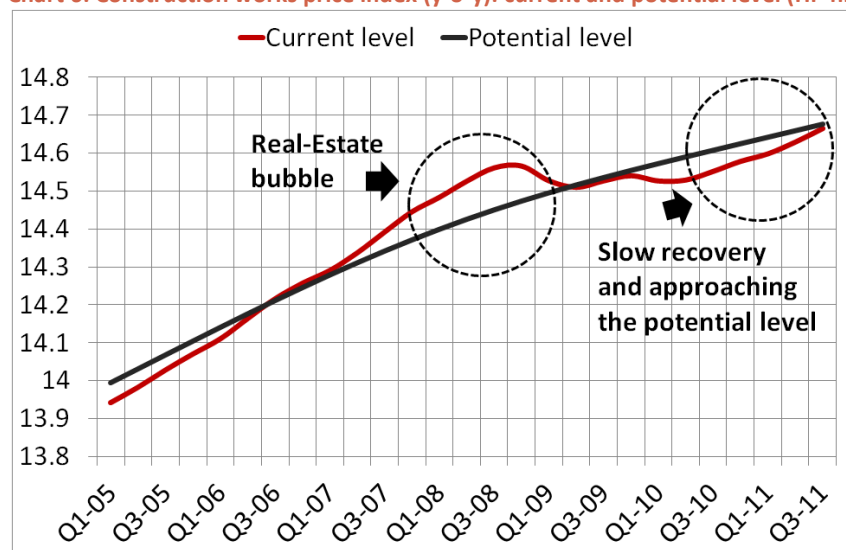
Source: NBS, NBM and EXPERT-GRUP calculations;

On the downside, the investments in residential buildings, at the end Q3’11, decreased by 13.3% and the amount of works on new real estate projects decreased by 15.4% in comparison with the previous year (Chart 5). At the same time, prices of apartments stagnated both on the primary and secondary markets, stabilizing at about 500-550 Euro/m<sup>2</sup> and 600-620 Euro/m<sup>2</sup> respectively. Moreover, the market became less liquid, as according to field experts’ it takes much more time to sell an apartment (2-3 months). It is also confirmed by a lower number of buying-selling transactions registered in September in comparison with the beginning of the year (-15.6%) and with the same month of 2010 (-12.9%).

**Chart 5. Breakdown of construction works, Q3'11, %, y-o-y**

Source: NBS;

This rather odd recovery owes to the bubble-bust cycle registered in the real estate sector during the last decade. Thus, after a period of strong growth in prices for apartments on primary and secondary markets, followed by a 35% drop during the recent economic crisis, the investors, banks and households became very skeptical and reluctant about financing new construction projects. As a result, so far, the sector recovers based on finishing the projects started earlier and current and capital repairs, as suggested by statistical data. Chart 6 reveals how slow the construction sector's recovery has been over the last 2 years. Thus, only at the end of the Q3'11, the price index of construction works, which is assumed to approximate the general state of the sector, almost approached its potential level<sup>10</sup>.

**Chart 6. Construction works price index (y-o-y): current and potential level (HP filter (1600))**

Source: NBS and EXPERT-GRUP calculations;

<sup>10</sup> The potential level is approximated with the Hodrick-Prescott filter:  $\min \sum_{t=1}^T (y_t - \tau_t)^2 + \gamma \sum_{t=2}^{T-1} [(\tau_{t+1} - \tau_t) - (\tau_t - \tau_{t-1})]^2$ , where  $\tau_t$  is the time trend,  $y_t$  is the initial variable (constructions prices index) and  $\gamma$  is the smoothing parameter set to 1600 (for quarterly data).

## Forecast

- The sector's future perspectives are quite uncertain, as it highly depends on both domestic and regional economic weather. Thus, the current sector recovery is viewed equivocally by real estate firms: for some of them the increase in demand and turnover fueled optimistic expectations, while others either remained in a gloom situation, being short of liquidities or perceive the current take off as a temporary one. As a result, according to the EXPERT-GRUP Business Confidence Index, the companies are equally spitted between those sharing positive expectations about future sector's perspectives (33.6%) and those expecting a worsening of sector's economic state (33.6%). This discrepancy once again reveals how unbalanced the current recovery in the real-estate sector is;
- The sector bears the full consequences of a bubble-bust cycle which, both theoretically and practically, will determine a series of tectonic changes in the near future. Hence, the real-estate sector will not look as vibrant as it used to be before the economic crisis. It is confirmed by the slow sector recovery which is likely even to cool down over the 2012 year and to stabilize at the proximity of its potential level;
- As an additional consequence of the bubble-bust cycle, the period of buoyantly increasing prices for real-estate is a thing of the past. Thus, the prices for apartments will stabilize at the current levels (550-600 Euro/m<sup>2</sup> on the primary market and 600-620 Euro/m<sup>2</sup> on the secondary market), without registering any major fluctuations during the next year. It is confirmed by the Business Confidence Index, according to which 55.2% of companies from the constructions sector expect no changes in the market prices of their goods and services over the next year, which is the highest share among all economic sectors;
- The new market circumstances will make the real-estate companies to switch to lower income market niches, particularly addressing the young families and households with average incomes. In fact, firms are already targeting these layers of population by designing new construction projects with smaller and, thus, more affordable apartments. At the same time, there is an oversupply of apartments built before the financial crisis, with wider areas and, designed for higher income households, which put downside pressures on the average market price. Real estate firms find extremely hard to find buyers for such apartments and, thus, incur losses from such projects.

## Policy recommendations

- The recent economic crisis and the burst of real-estate bubble revealed a series of systemic deficiencies of the constructions sector, which were hidden by robust growth and groundless optimism surrounding the market. Now, a significant constraint holding back the sector's development consists of a series of fundamental legislative and regulatory issues which undermine the competition and investment attractiveness of the sector;
- For example, the Law regarding public acquisitions stipulates that the auction's winner should be the company offering the lowest price<sup>11</sup> which creates advantages for the companies providing low quality services and leaves room for illegal arrangements. Respectively, it is necessary to rethink this regulation, such that the law should make companies to compete not only based on the price, but also on their experience, profile and technology available;
- Additionally, the legislation lacks any clear stipulations regarding the relations between investors/customers and construction companies, which is odd as most construction projects are co-financed through the advance payments of customers. Thus, it is necessary to ensure a better regulation of interactions between these two types of economic agents, with a

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<sup>11</sup> Law no. 96 from 13.04.2007 on public acquisitions, art. 54

- special emphasis on the guarantees offered by the construction companies to investors. It will consolidate the confidence in these firms and, consequently, will provide them with wider access to financing;
- A major constraint for sector development and FDI attraction is the burdensome process of obtaining construction permits. It is confirmed by the construction companies, as well as by international rankings (e.g. 164<sup>th</sup> place out of 183 countries according to the ease of obtaining construction permits in World Bank's Doing Business Report 2012). Hence, it is necessary to further simplify the process of obtaining these documents in terms of time and bureaucratic procedures.



## 7. Services

### A case of steady recovery

During the first two quarters of 2011 the service sector has accounted for nearly 65% the GDP, this share is virtually identical to that registered during 2010. Also during that period the sector expanded by 7%, however just like in Q1'11 this growth was down to the service sub-sectors that bear a low added value. Thus, traditionally, the consumption outburst resulted in higher growth of retail trade and repairing of vehicles and other goods – overall these sub-sectors have registered an 18.3% growth y-o-y.

Following the trend depicted in the previous edition of MEGA, the hotel services have almost recovered the pre-crisis positions. The number of tourists placed in collective touristic accommodations during Q3'11 has reached 97% of the corresponding figure registered in Q3'08. This performance is indeed remarkable mostly because of the relatively short time frame necessary for a full recovery. Obviously the hotel sector greatly benefited from the 34% increase in the incoming number of tourists registered during the first three quarters of 2011 y-o-y. The increase in the outgoing number of tourists was less notable (17% y-o-y), yet the gap between the outgoing and incoming flows is still expanding. During the period under review it increased by nearly 16%.

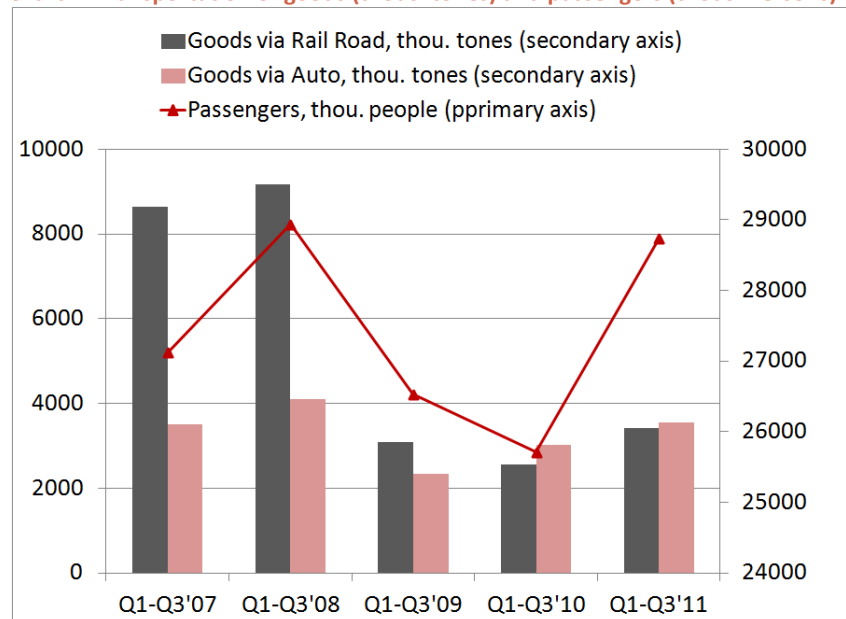
The transportation services are also experiencing a positive evolution, but considering the slow pace of recovery it is unlikely for the sector to attain the pre-crisis performance any time soon. The rail road transportation - hit the hardest back in 2009 - have experienced the most pronounced growth in the entire range of transportation services. During the first 10 months of 2011 the amount of goods transported via rail road has increased by 26% y-o-y. Yet, this growth rate has only slightly contributed to the subsector's come back – in January – October 2011 the quantity of transported goods via rail road constituted only 38% of the amount registered during the same period of 2008.

As mentioned in previous editions of MEGA, the balance of payments for the first two quarters of 2011 suggests that local companies are increasingly contracting foreign suppliers of auto transportation services as an alternative for the local options. Apparently, the preference of auto transport supplied by foreign suppliers is mostly detrimental for rail road transportation rather than for auto transportation services supplied by local providers. However, there are some administrative problems to add up to the problems of the rail road TS sub-sector. According to the result of the audit performed by the Court of Accounts of Moldova, up until august 2011 the state enterprise did not have an internal regulation that governs the transport of goods and the tariffs applied. The contracts with the clients were set at varying prices, did not contain all the necessary information and reflected fraudulent behaviour. These practices ultimately resulted in lower revenue for the state company. To some extent the deficient administration of the company influences the companies' decision to choose other transportation options.<sup>12</sup>

The amount of goods transported by road has also registered a shift of 16% y-o-y. However, unlike the case of rail-road transportation this period of time finally marks the nearly full recovery of road transportation services - the volume of goods reached 98% of the amount transported during the corresponding time section of 2008 (Chart 7).

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<sup>12</sup> Decision no. 31 /08.08.2011 regarding the audit report of the public assets management performed by "Moldovan Railways" in 2009-2010

**Chart 7. Transportation of goods (thous. tones) and passengers (thous. Persons)**

As for the transportation services provided to the population the trends are rather mixed across different transportation means. During the first 10 months of the year the number of passengers using air and auto transportation services have increased by 6% and 8% respectively. For the first three quarters the rail road transportation has experienced a slight decline of 4%. The recent audit performed by the Court of Accounts of Moldova reveals that the prices set for the tickets hardly account for a fraction of the incurred costs. Only in 2009 the diesel costs have increased four folds, yet the ticket prices have remained virtually unchanged. Consequently, the financial management of the Moldovan Rail Road favours the passengers at the expense of the company's wellbeing, and this represents a part of the governmental social protection policy. Should this strategy remain unchanged the company might face significant financial difficulties in the upcoming years.

For the next year, business confidence in retail trade sector is positive (business confidence index of 0.071), while in other service sub-sectors it is slightly negative (business confidence index - -0.007). Nevertheless, in both sub-sectors companies are optimistic regarding their sales, number of employees and even investments for the next 12 months<sup>13</sup>.

## Forecast

- Despite the registered growth rates, the rail road transportation of goods remains a significant problem in the way of the sector's recovery. Should the administration of the Moldovan Rail Road pursue the current financial strategy the sub-sector is unlikely to recover more than 40% of pre crisis performance up until the end of the year;
- The hotel sector is showing great promise this year. In fact, the number of accommodated tourists might as well exceed that registered in 2008 by 1-2% by the end of 2011. However it is also important to mention that the hotel sector is demand driven and its recovery has hardly anything to do with the government' efforts (of lack of thereof). The number of accommodated tourists depends on the overall state of the economy rather than on the quality of the hotel services in particular. Consequently it is difficult to give an accurate estimate of the sector's evolution in the medium and long run.

<sup>13</sup> According to Business Confidence Survey conducted by Expert-Grup in November 2011

## Policy recommendations

- In the light of the audit results obtained by the Court of Accounts the Moldovan Rail Road should revise its long run financial strategy. It is recommended to balance out the fees applied in respect of the transportation services supplied to passengers and those applied in respect of transported goods. More specifically, the company should cease the practice of subsidizing the former at the expense of the latter. In addition it is recommended to adjust the administrative procedure of signing contracts.

## 8. Labour Market

### Supply-demand mismatch and informal employment on the labour market

At the first sight the post-crisis situation on the labour market is still volatile with weak recovery signs. While in Q3'11 employment rate increased, no stalwart recovery trend was registered throughout the whole year. A deeper look into the data suggests that this is both a decade-long structural change and a lasting effect of the economic crisis. On the one hand, construction sector is still shrinking in terms of employment (by 4% in Q3'11 y-o-y) and agricultural sector is very volatile in providing jobs, the number of employees registering significant fluctuations that cannot be explained as variations due to sample error. On the other hand, industrial sector shows a healthier recovery already for three quarters in row. Additionally, in service sector currently employment is higher than prior to the crisis. However, the rise was mainly in trade sub-sector, with lower value added activities.

Even though in Moldova the deficit of vocational education and surplus of tertiary education graduates is often invoked as a key constraint to economic growth, in fact, the number of employees with higher and post-secondary not-tertiary education increased the most, while the number of employees with secondary education dropped. Thus, individuals seem to be rational in their choice based on the employment patterns.

Currently, the Government seems to be really concerned about the existent mismatch on the labour market, setting "Studies: relevant for the career" as a priority for the next National Development Strategy "Moldova 2020". Indeed, according to WB Enterprise Survey, Moldova is a leading country in the region when it comes to the dissatisfaction of employers of the quality of labour force (with 41% of employers indicating labour skill level as a major constraint to their activity<sup>14</sup>). Nevertheless, the draft strategy gives a vague idea on how Moldova is going to look like in 2020 in terms of its human capital. Besides some indicators that should be achieved and problems identified in the system, it does not provide clear reasoning of the chosen targets (is it a optimal target by international standards or something that Moldova is able to achieve in this period taking into consideration the available resource and general development framework of the country?) and provisions on how they will be achieved.

Although few types of mismatches might exist (over/under-qualification, over/under-education, over/under-skilled), some basic calculations should be done using existing data in order to gauge the degree of the mismatch and design policy interventions. For example, the coefficient of variation<sup>15</sup> for employed vs. working age population indicates that the mismatch has increased from 20.8% in 2001 to 42.1% in 2010, mainly because of lower employability of lower educated individuals. The coefficient of variation is lower for the youngest group of population (25-34). However, when we look at the coefficient of variation of employed vs. unemployed population we find a higher mismatch for the youngest cohort (Chart 8).

<sup>14</sup> World Bank Enterprise Survey, 2009;

<sup>15</sup> Coefficient of variation compares the degree of variation from one data series to another; it is calculated as the ratio of the standard deviation to the mean, multiplied by 100 to be expressed as a percentage. In order to determine the mismatch on the labour market the employed population is compared with working age population and unemployed population and the coefficient of variation between the two data series is calculated based on the educational attainment;

**Chart 8. Coefficient of variation for employed vs. working age population and employed vs. unemployed population, %, 2001-2010**

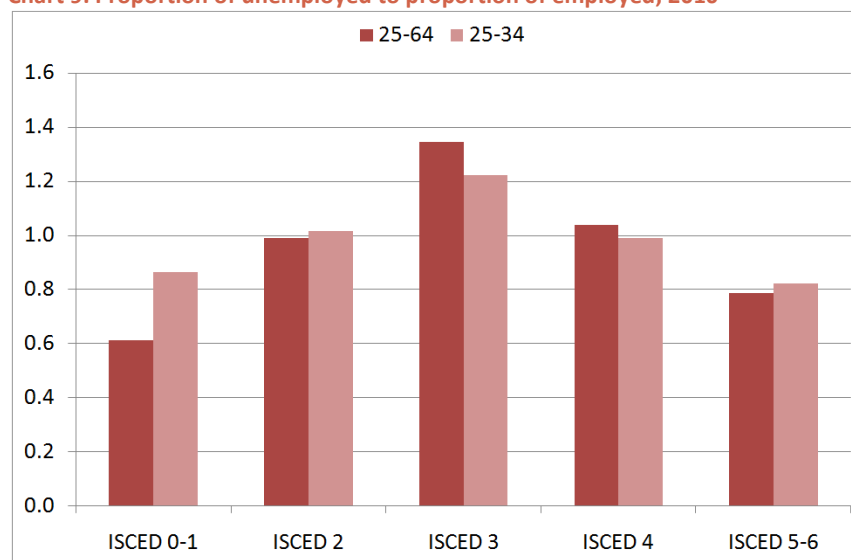


*Note: The coefficient is calculated for population 25-64 that is supposed to finish all levels of education;*

*Source: EXPERT-GRUP calculations based on NBS data;*

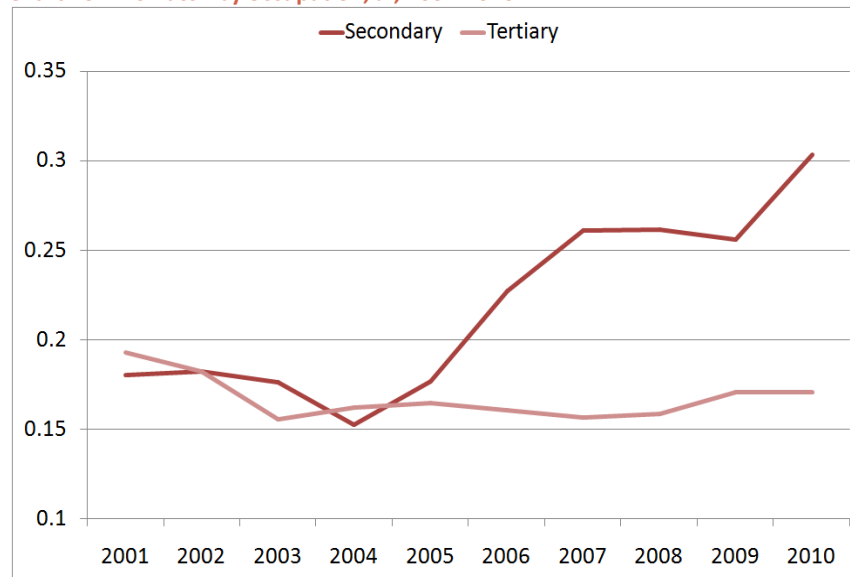
Thus, the coefficient of variation reveals the existence of the mismatch on the labour market and proportion of unemployed to proportion of employed identifies the groups of population with higher mismatch, in 2010 represented by lower educated population (Chart 9).

**Chart 9. Proportion of unemployed to proportion of employed, 2010**



*Source: EXPERT-GRUP calculations based on NBS data;*

Another important indicator that also takes into account the type of job performed is the mismatch by occupation. It also indicates a higher mismatch for the vocational education graduates, but points to the existence of mismatch for tertiary graduates too (Chart 10) – 17% performing jobs requiring lower qualifications (compared to 31% for secondary education graduates).

**Chart 10. Mismatch by occupation, %, 2001-2010**

*Note: Mismatch for secondary level graduates is calculated as the ratio of workers not in education with ISCED 3-4 education, working at skill level ISCO 9 to all workers not in education with ISCED 3-4 education; Mismatch for tertiary level graduates is calculated as the ratio of workers not in education with ISCED 5-6 education degree, working at skill level ISCO 4-9 to all workers not in education with a tertiary education;*

*Source: EXPERT-GRUP calculations based on NBS data;*

Most of above listed indicators do not account for the quality of education. However, it is certain that the vocational education faces the most serious quality problems and Moldova needs more properly educated graduates both with vocational and tertiary education.

Another important trend on the labour market is the decline of informal salaried workers during 2011 with no signs of change in non-declared wages. This behavior is interesting due to its manifestation in a period of a great governmental concern regarding the issue of informal employment.

The State Chancellery launched for the period Q3'11 the elaboration of 16 public policies. The Ministry of Labour and Social Protection and Family (MLSPF) was given the task to work on a strategy of decreasing the informal employment, however no clear target was defined: is the policy objective to shrink the informal employment in the formal sector (wage earners without a contract or non-declaration of the wages) or rather to reduce the informal employment in the informal sector (self-employed, people working in their own households) or both indeed. The two types of informal employed are totally different and need different approaches. Currently, the role and the task of the MLSPF are not clear. If one refers to informal employment in the informal sector, with highest share in agricultural sector, then there is a need of structural economic reforms that should be co-authored with other line ministries. Certainly, reduction of informal employment in this sector, which is happening naturally, without the creation of new jobs in the same or other sectors is not a solution. Moldova would not benefit from turning informal employment into unemployment.

As for addressing the informal employment in the formal sector, the Governmental approach is not fully justified. There will be always incentives for tax evasion as long as the population is generally not satisfied with the public services received. Fines may reduce the tax evasion, but will not eliminate it; and, moreover, it should be the task of fiscal administration. Thus, it seems that only because its name includes the word "labour", the MLSPF was assigned tasks which are inappropriate for its mission.

## Forecast

- For 2011 we expect stabilization on the labour market with employment rate at about 40% and unemployment rate at 6.5-7%;
- Further evolution of the labour market will depend on the state of global and regional economy. A recession in European Union might have bad consequences for Moldova, including shrinking employment in service and industrial sector, returning migrants and rising unemployment. Opposite to this, improvement of the global economic outlook coupled with growing integration of Moldova into the European market would create new opportunities for employment through higher FDI and more intense economic activity;
- Expected introduction of fines and sanctions for non-declaration of wages will decrease informal unemployment only marginally.

## Policy recommendation

- It is necessary to implement a correct and documented approach for the human capital development in Moldova. Moldova 2020 draft strategy does not provide such a framework. All further actions should be promoted based on research and included in an action plan. It is necessary to elaborate at least simple projections for the labour market needs (based on replacement demand and trends in economic sectors) and to identify the mismatch on the labour market based on available data;
- Investing in continuous education and training emerges as a key priority. The share of adults participating in training is very low in Moldova. The needs for continuous education and training are getting higher not only due to changing economic patterns and developing technologies, but also because of the low-educated population leaving gradually employment in agricultural sector. Employing this labour in other economic sectors requires more resources from both the state and the companies;
- Adopting a comprehensive action plan for fighting informal economy, with all line ministries involved for promoting sectoral reforms. The MLSPP should be responsible for the assessment of the impact of every action on the labour force and the estimation of costs and benefits for the social protection system.

## 9. Households

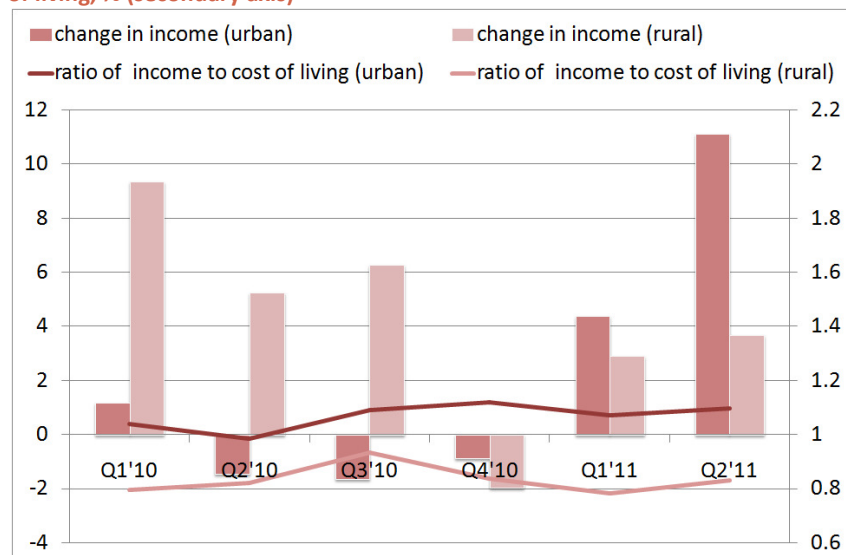
### “Shopping fever” vs. “starvation line”

Since late 2009, households' revenues have been on the recovery path, with a single negative fluctuation in Q4'10. However, they continue to rise during 2011 with one important feature. While the disposable income growth of urban households was more impressive, the advance of income of the rural ones slowed down. Indeed, this might be a delayed recovery effect as in 2010 only income in rural areas increased; however, incomes still lower than cost of living and very high poverty rates in rural areas reveals the sternness of the current situation.

It is true that according to the last report on poverty for 2010<sup>16</sup> published in Q3'11, the poverty rates reached historical minimum. Absolute poverty rate decreased from 26.3% to 21.9% and extreme poverty rate dropped from 2.1% to 1.4%, a better than pre-crisis situation. Moreover, in contrast to previous years, this was a result of falling poverty rates in rural areas and small towns. However, the relevance of the poverty lines is questionable. The extreme poverty line set at 549.4 MDL asserts, fairly enough, a “starvation line” if to look into the nutrition norms used by the Ministry of Economy for its calculation. We won't contradict the statement that it is possible to survive with this level of consumption, as probably many of those under the poverty line consume not more than these norms, but we question the relevance of the indicator for other state policies. The minimal income guaranteed by the state is set very close to the extreme poverty line. It should be more appropriate to use absolute poverty line<sup>17</sup> or even cost of living level if the social policy truly intends to improve the living standards of the population and to help people overcome difficult periods in their lives.

Thus, the parallel evolution of incomes and living cost reveals better the current situation of population (Chart 11). In Q1 and Q2'11 only in urban areas the gap between two series narrowed, while in rural areas no improvement was registered.

**Chart 11. Evolution of disposable income, %, y-o-y (primary axis) and the ratio of disposable income to cost of living, % (secondary axis)**



Source: NBS and EXPERT-GRUP calculations;

<sup>16</sup> Information Note: Poverty in the Republic of Moldova in 2010, Ministry of Economy, July 2010

<sup>17</sup> Absolute poverty line is calculated as extreme poverty line multiplied by the inverse coefficient of share of food expenditures of households with expenditures in a small interval from the extreme poverty line. The coefficient was set 1.85



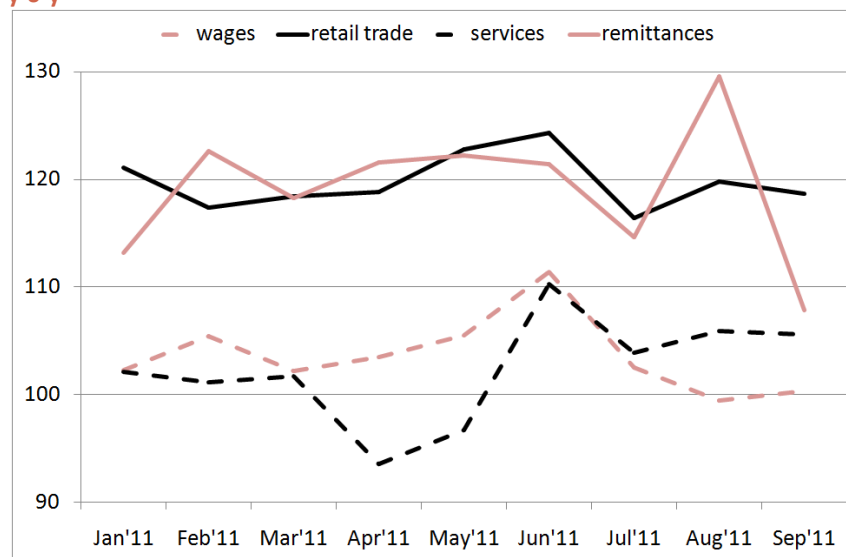
This pattern occurred when all most important sources of revenues for rural inhabitants rose .... except remittances. Thus, even though the data from Household Budget Survey (HBS) are not comparable to those from balance of payment (BoP), an interesting fact is that remittances in rural areas are on the downward trend for already three quarters in row, while before the crisis they advanced stronger than the one received by urban inhabitants. Indeed, this is an interesting trend that might be explained by the internal mobility in the country, with children who already moved to cities and towns continuing to receive, already as urban inhabitants, remittances from their parents. Nevertheless, this trend may have serious implications on the poverty rates, the potential of remittances to contribute further to poverty reduction being limited.

Meanwhile, remittances moved to a milder growth path, judging by the transfers in favor of natural persons through banking system. In September, the annual increase was in one-digit range after a spectacular growth during spring and summer. Obviously, this is the impact of higher comparison base in late 2010, but also of the more vivid signs of an upcoming crisis in Europe. This is visible from different growth rates of remittances in BoP from Russia and other CIS countries and from EU countries, but also from the changing currency structure of the transfers. Thus, the remittances in RUR almost doubled in 2011, revealing distrust in EU and partially USD currency in the anticipation of a new wave of the crisis.

The lack of confidence in the foreign markets reflected into the savings of the population. These reacted to the cooling down of inflows of remittances with only one-month delay. Nevertheless, the deposits in MDL grew to a higher extent, while the ones in foreign currency have a stable trend. In September and October, the growth rate accounted for 6.8% and 1.3% respectively, compared to 40.8% and 26.7% for deposits in MDL.

Even in these terms, remittances are the main source to fuel consumption, as the modest increase in wages in Q3'11 could barely explain the "shopping fever" (Chart 12). The turnover in retail trade was on average 19.7% this year, not comparable to any pre-crisis year, though the methodology was also changed. At the same time services rendered to the population advanced slower, with some stronger advance in Q3'11.

**Chart 12. Evolution of wages, remittances, turn-over in retail trade and services rendered to population, %, y-o-y**



Source: NBS, NBM and EXPERT-GRUP calculations;

These trends are partly reflected in the general assessment of the population of their financial status<sup>18</sup> over the last year, with 40.5% considering the situation to have worsened and only 13.2% to have improved. The most affected seems to be the rural population, but also in Chisinau and Balti and older population (68.5% of those aged 50-70 consider the financial situation of their family to worsen in the last year). Nevertheless, the population is more optimistic about the evolutions for the next year, with only 18.7% of population expecting a decrease in their income and 26.8% being optimistic in this regard. A quite interesting fact is the assessment of a specific group: employees. The respondents giving a negative assessment of the evolution of their income in the past 12 months were mainly public employees, while those expecting decline in their income in the next year are the employees in private sector, who might be more exposed to the crisis peculiarities and be aware of it.

## Forecast

- Although the population is more optimistic about their future income, further developments depend very much on the situation on foreign markets that is not only "responsible" for the inflows of remittances in Moldova, but also for the jobs in some export-oriented industries. We expect the reduction of growth of remittances, so that by the end of the year will reach about 10% increase y-o-y. As for 2012, it will further moderate or even turn into negative in case of the worst scenarios for the leading global economies;
- The wages will also follow a stable path until the end of the year, as there are no plans for rise or cut in wages in public sector that usually have a significant impact on the overall change in wages. Despite still growing economic activity, employers in many sector tend to act cautiously in the current uncertain situation where despite the apparent growth, the fear of a new wave of crisis is very strong. Thus, by the end of the year we expect an increase of real wages of 2.5%;
- Nevertheless, consumption will stay on its stable growth path, reacting with a short delay to the economic risks. The turnover in retail trade and services rendered to population will reach 13% growth by the end of the year, with uncertain change for the next year;
- As regards the deposits of the population in the commercial banks, they are currently influenced both by changes in income and lack of confidence in external situation and explicitly in Euro currency. In short-term this might reduce the willingness of population to stock the money in banks.

## Policy recommendations

- The social policy of the country should be revised. Currently, there are too many interfering concepts: social benefit, unemployment benefit, different kinds of compensation; these should be linked all together so that the system is simplified and all these benefits reach the most vulnerable groups;
- Additionally the role of the social policy should be rethought in order to have a positive impact on the society and human development of the country. The current social policy aims to satisfy basic physiologic needs of the poor, instead of helping them integrate in the society through access to education, health and other public services;
- Supporting rural population will be a real challenge for the Government in the next few years. The mid-term development framework of Moldova should put more emphasis on regional development, providing opportunities to rural population.

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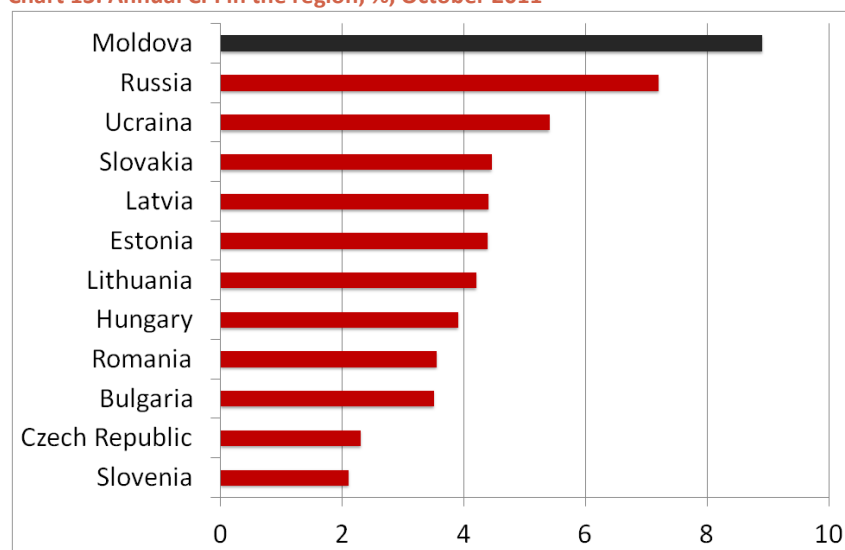
<sup>18</sup> According to Consumer Confidence Survey conducted by Expert-Grup in November 2011

## 10. Prices

### Peculiarities of a cost-driven inflation

At the end of October 2011, the annual headline inflation picked to 8.9% level, owing to a series of strong supply-side shocks (regional spikes in food and energy prices, weather conditions worsening and adjustment of tariffs for utilities), as well as consolidation in population's disposable income. This deadly mix of inflationary pressures determined in Moldova the highest price increase in the region (Chart 13). Besides traditional adverse long-term effects on the economic activity, Moldova is highly exposed to significant social repercussions of high inflation. The negative social impact is related to several peculiarities of the economic system: (i) poor level of financial intermediation and thin capital market creates high opportunity costs of holding money, as households keep their savings outside the financial system; (ii) rudimentary pensions system (PAYG) based on an old-fashioned backward looking indexation mechanism (e.g. in 2011 pensions were indexed by 7.4% which – lower than the inflation rate the same year); (iii) the lowest income level in Europe makes the Moldovan population especially vulnerable to inflationary threats.

Chart 13. Annual CPI in the region, %, October 2011



Source: National Statistical Offices of each country;

During the summer period, the foodstuffs had the main contribution to the overall increase in annual CPI. The main determinants of food price inflation were related to:

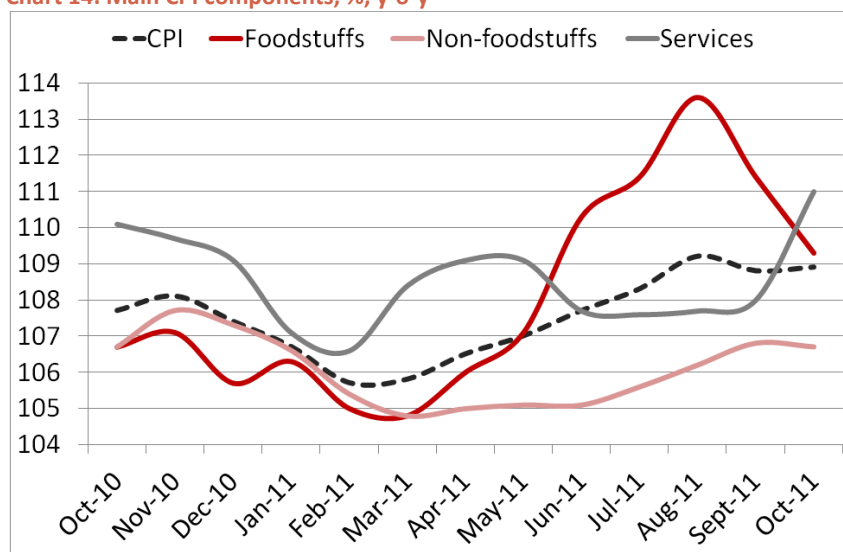
- **Worse weather conditions in comparison with the previous year.** It mitigated the seasonal disinflation during the summer due to poorer harvest of fruits and vegetables. As a result, at the end of August the prices for foodstuffs catapulted to 13.6%, mainly driven by price increases in potatoes (+36.7), vegetables (+28.6) and fruits (+17.1%);
- **The effect of imported inflation.** Price spikes at the regional and international level constitutes an important transmission channel for the Moldovan economy. In this way, the international food prices index surging by 33% in July, in y-o-y terms<sup>19</sup>, implied corresponding domestic adjustments. Some relevant examples are related to impressive price hikes on eggs, sugar and wheat flour by 58.7%, 17.3% and 12% respectively;

<sup>19</sup> The World Bank, "Food Price Watch", August 2011.

- **Propagation of second round effects of energy and utilities prices increases at the beginning of the current year.** The latter translated into higher input costs for agricultural and foodstuff producers. It mainly influenced the bread and bakery products (+9.2%) and milk and dairy products (+12.9%).

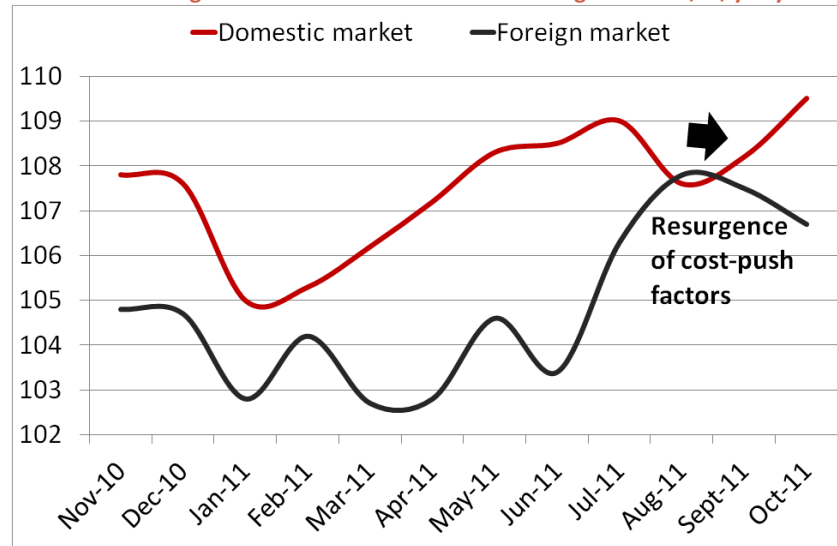
However, starting from September, the food-price driven inflation waned on the grounds of higher comparison base and wearing off the second round effects of energy and utilities prices increases at the beginning of 2011. At the same time, during the first 2 months of autumn the CPI was again fueled by utilities (Chart 14). Hence, at the end of October, the prices for services grew by 11.1% y-o-y, the main spikes belonging to central heating (32.2%) and gas supply (40.1%), owing to tariff adjustments as a result of higher import prices for natural gas.

**Chart 14. Main CPI components, %, y-o-y**



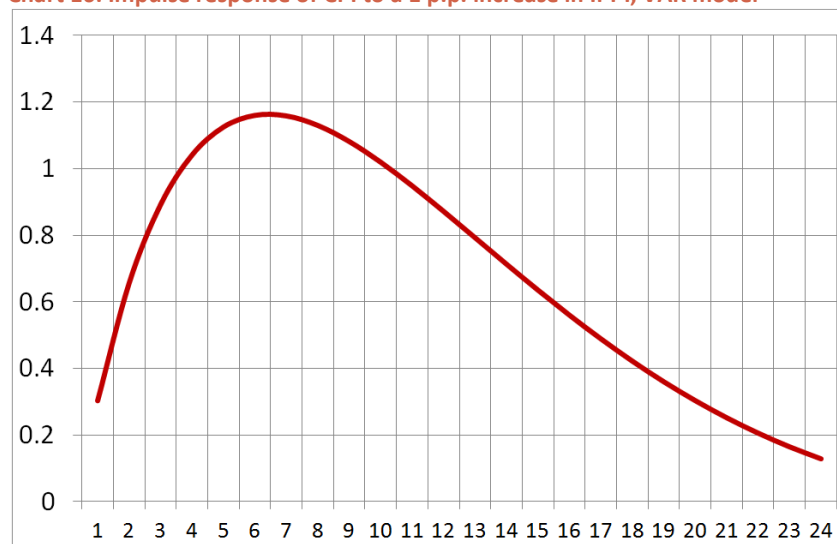
Source: NBS;

One of the main peculiarities of Moldova's inflationary environment is the persistent influence of cost-push factors and adverse supply-side shocks which are extremely challenging for the monetary authority. This is explained by at least three fundamental constraints of the national economy: (i) low energy security; (ii) high vulnerability to weather conditions due to weak and uncompetitive agricultural sector; and (iii) poor domestic supply and high dependence on imports. These constraints generated at least three shocks over the current year: two tariff adjustment for utilities and growing prices for fruits and vegetables. Hence, the discrepancy between annual headline and core inflation, over the first 10 months of 2011, was 3.8 p.p. on average. Additionally, the industrial producers' prices index (IPPI) for goods sold on the domestic market rose by 9.5%, being driven by the production of electricity (+12.9%) and steam and hot water supply (+14.7%). In case of the last one, the increase in input prices paralleled with a y-o-y drop in industrial production by 0.9% at the end of the Q3'11.

**Chart 15. IPPI for goods sold on the domestic and foreign markets, %, y-o-y**

Source: NBS;

The Chart 15 denotes the resurgence of cost-push inflationary pressures on the grounds of higher input costs incurred by domestic producers. According to our empirical simulations, a 1 p.p. increase in IPPI generates a strong shock for the headline inflation which reaches its maximum after 5-6 months when CPI also increases by 1 p.p. (Chart 16). It leads to 2 important conclusions: on the one hand the producers fully incorporate, with some lags, all input price shocks into the final consumer prices and, on the other hand, the impact of cost-push factors is persistent for about 2 years when the shock dies out completely. Therefore, it supports the statement that we should expect a strong disinflationary trend in 2012, assuming no additional shocks in this period.

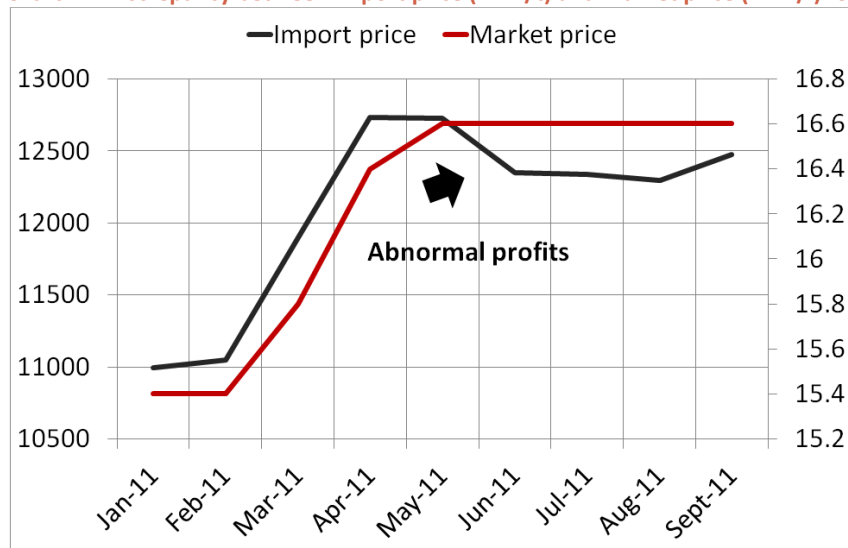
**Chart 16. Impulse response of CPI to a 1 p.p. increase in IPPI, VAR model**

Source: EXPERT-GRUP calculations;

Another important source of cost-push shocks on the general price level is related to poor competition and inefficient regulations of particular markets. One of the most relevant is the domestic market of petroleum products where due to high concentration levels and odd regulatory framework, the producers can derive abnormal profits from inert and unjustified domestic price adjustments. This is revealed by the firms' reluctance to decrease the prices for gasoline and diesel despite lower import prices (Chart 17 and Chart 18). Additionally, our empirical estimations reveal an

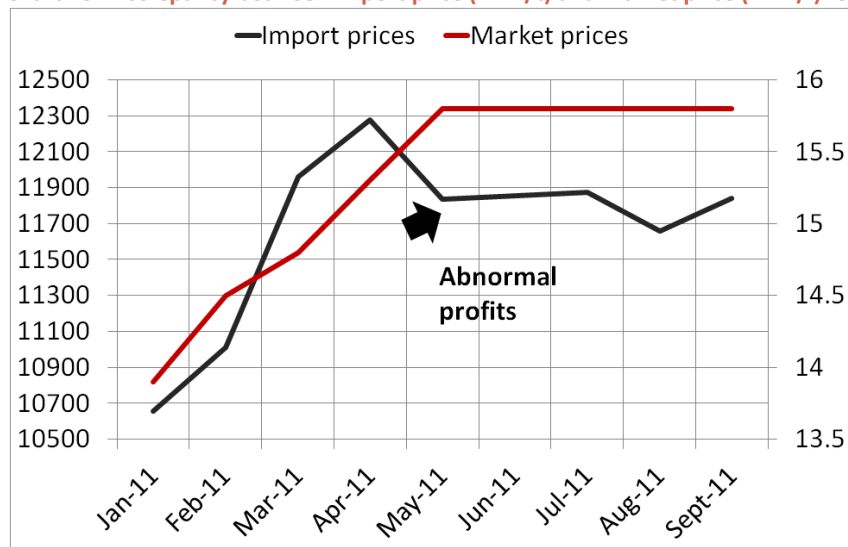
asymmetric price adjustment of domestic prices to foreign and exchange rate shocks, such that the price elasticities in periods of increasing import prices are much higher than in periods of lowering import prices<sup>20</sup>.

**Chart 17. Discrepancy between import price (MDL/t) and market price (MDL/l) for gasoline**



Source: National Agency for Energy Regulation and EXPERT-GRUP calculations;

**Chart 18. Discrepancy between import price (MDL/t) and market price (MDL/l) for diesel**



Source: National Agency for Energy Regulation and EXPERT-GRUP calculations;

## Forecast

- The recent tariff adjustments for natural gas and heating will imply two-round effects on the headline inflation: (i) the direct increase in the corresponding components of CPI basket and (ii) the increase in production costs which will be gradually spread across other products. It shaped correspondingly the firms' expectations about future hikes in input costs: according

<sup>20</sup>  $\log(\text{Domestic\_Price})_t = \beta_0 * \lambda + \beta_1 \log(\text{Platts}_t) * \lambda + \delta_0 * (1 - \lambda) + \delta_1 \log(\text{Platts}_t) * (1 - \lambda)$ ,  
where:  $\lambda = \Delta \text{Platts} \geq 0$ ,  $\beta_1 = 0.6$  and  $\delta_1 = 0.48$  (for benzene) and  $\beta_1 = 0.47$  and  $\delta_1 = 0.42$  (for diesel)

to the Business Confidence Index<sup>21</sup>, 67.4% of companies surveyed expect an increase in production factor prices over the next year. Interestingly, fewer of them correlate these expectations with anticipated increase in market prices of their goods and services, as only 44.1% of interviewed firms plan to adjust their prices upwards;

- Until the end of 2011 the annual CPI is expected to reach the level of 9.5%, while during 2012 it could decrease to 6.5-7% if no additional adverse supply-side shocks will occur. This outlook is supported by the companies' inflationary expectations. Thus, according to the BCI, 46% of interviewed firms are planning to keep the final prices unchanged over the next 12 months, owing mainly to economic uncertainty surrounding the domestic and foreign macroeconomic environment.

## Policy recommendations

- The relevant authorities should take more active steps towards improving the regulatory framework and ensuring an authentic competitive environment on many crucial economic markets for the Moldovan economy (e.g. petroleum products, pharmaceuticals, meat, dairy and other foodstuffs etc.). It will prevent the future adverse supply-side shocks on the price level and will significantly enhance the business climate and will increase the consumers utility.

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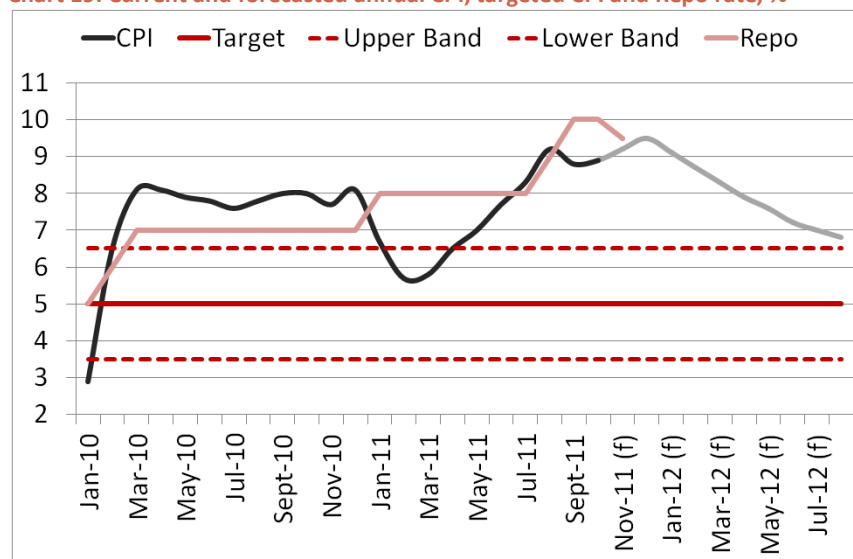
<sup>21</sup> According to Business Confidence Survey conducted by Expert-Grup in November 2011

## 11. Monetary Policy

### Inflation targeting peculiarities amid high uncertainty

Buoyant domestic demand driven by remittances inflows and an impressive credit expansion, coupled with adverse supply-side shocks, have boosted upside risks on the inflation front. As a result, the National Bank of Moldova (NBM) continued tilting towards the hawkish side, by raising its main refinancing rate by 1 p.p. in August and September up to 10%. In this way, the central bank tried to anchor the inflationary expectations within the targeted interval of 5% ( $\pm 1.5$  p.p.) which, according to our estimations (Chart 19) are likely to approach the upper bound of NBM's target already in 2012.

Chart 19. Current and forecasted annual CPI, targeted CPI and Repo rate, %



Source: NBM and EXPERT-GRUP calculations;

Given the forward-looking behavior of the central bank, it already started to adjust its policy stance to the descending inflationary expectations which can turn to be even stronger unless the European policy makers will find a decent exit from the current sovereign debt crisis. Given such a high level of uncertainty surrounding the world economy, NBM reduced, at the end of November, its main refinancing rate by 0.5 p.p. (from 10% to 9.5%), keeping a highly inert policy adjustment. However, if we take into account that in approximately three quarters the headline inflation could decrease to about 7% or even lower (in case of worsening of external economic conditions), the current monetary policy stance remains appropriate and does not even seem to be an accommodative one.

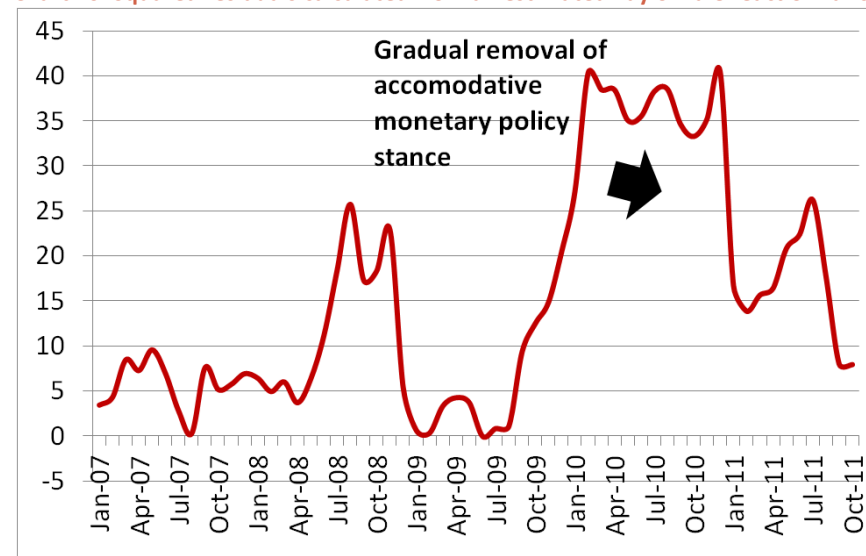
Moreover, the empirical evidence confirms that in 2011 NBM almost completely withdrew its accommodative policy stance which persisted during 2010. Thus, the analysis of squared residuals estimated from a simple central bank reaction function<sup>22</sup> revealed its increased inflation aversion over the current year (Chart 20). Such a policy shift works relatively well for the macroeconomic stabilization and for steering the inflationary expectations. At the same time, it ensures the central bank a sufficient room for maneuver for the next year which will be extremely challenging, as the

<sup>22</sup> The squared residuals were calculated from an estimated Taylor rule reaction function:  
 $repo_t = \beta_0 + \beta_1(\pi_t - \pi_t^*) + \beta_2(IPI_t - IPI_t^*) + \varepsilon_t$ , where:  $\pi_t - \pi_t^*$  is the deviation of current annual inflation from its trend (HP filtered) and  $IPI_t - IPI_t^*$  is the deviation of the annual industrial production index from its potential level (HP filtered).



domestic economic growth is expected to take a hit, while the risks of economic meltdown in the euro area are high.

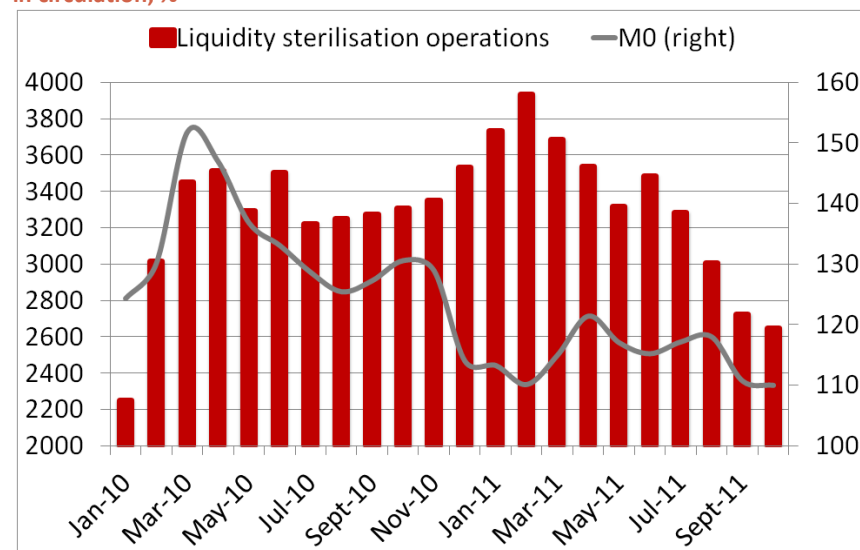
**Chart 20. Squared residuals calculated from an estimated Taylor rule reaction function**



Source: EXPERT-GRUP calculations;

NBM continued its open market operations aimed at mopping up excess liquidity, despite the fact that this is not its main objective and it incurs many losses by being a net borrower of the banking system. However, the daily stock of NBM certificates sold to commercial banks sloped downwards over the current year, owing to monetary policy tightening and credit expansion. At the same time, this trend was paralleled by the maturing growth of money in circulation, which cooled down the monetary inflationary pressures (Chart 21).

**Chart 21. Daily stock of sterilization operations performed by NBM (million MDL) and y-o-y growth of money in circulation, %**



Source: NBM and EXPERT-GRUP calculations;

During January – August 2011 the national currency has constantly appreciated by 7% on the grounds of robust growth in exports and remittances. This appreciation pace could have been even steeper without central banks interventions on the foreign-exchange market by purchasing the excess

foreign currency. Thus, the seasonal increase in remittances' inflows during the summer months, determined NBM to purchase about USD 21.5 million during June-August. As a result, the international reserves peaked to about 5 consecutive months of imports coverage which ensures the central bank with enough munitions to counteract eventual macroeconomic shocks. During September and October, the national currency depreciated by 1.9% and 1.7% respectively, owing to seasonal increase in energy imports.

## Forecast

- The Europe's sovereign debt crisis and the continued slack in several eurozone countries determined a very uncertain foreign macroeconomic environment with obvious spillovers for the domestic economy. This is likely to be the main challenge which NBM will be facing in the near future. As a result, over 2011 the central bank implements a highly inert monetary policy by spreading its policy decisions over several periods of time, which is likely to continue during the next year<sup>23</sup>. It, also, explains the recent NBM decision to decrease by only 0.5 p.p. its REPO rate, which is likely to be the beginning of a constantly easing monetary policy;
- The inflationary pressures will subside during the next year as the cost-push shocks will wear off while the entire economy will reduce its growth momentum. This is confirmed by the Expert-Grup Business Confidence Index<sup>24</sup>, which states that only 27.4% of surveyed companies expect that the economic situation in their sectors will be better over the next 12 months. The rest of firms, either expect a stagnation (42%) or recession (30.6%). Thus, the annual headline inflation could enter the central bank's targeted interval by the end of 2012. Upon realization of these expectations, coupled with recessionary risks in the euro zone, NBM could face the challenge of a strong disinflation, which could even call for some easing steps during the next year.

## Policy recommendations

- In order to ensure a high "easing potential" and, thus, sufficient room for maneuver in case of economic crisis, the central bank should keep the current monetary policy stance until there will appear some clear evidence of economic recession at the regional level. Thus, in case of a worst-case scenario, NBM will be sufficiently equipped to mitigate the eventual economic or financial crisis;
- The analysis of NBM's reaction function over the recent years denotes a discretionary rather than a rule-based monetary policy. Therefore, based on the international experience, this amount of discretion should be counterbalanced by a more transparent and accountable decision-making process. Particularly, it should imply publishing of minutes of each monthly board meeting, with information about member's votes, forecast and different scenarios taken into account by the central banks.

<sup>23</sup> This monetary policy gradualism is confirmed by the high coefficient (0.95) of the autoregressive component of policy rate incorporate into the central bank's reaction function, which is estimated as follows:  $repo_t = 0.54 + 0.95repo_{t-1} + 0.12(\pi_t - \pi_t^*) - 0.001(IPI_t - IPI_t^*) + \varepsilon_t$ .

<sup>24</sup> According to Business Confidence Survey conducted in November 2011

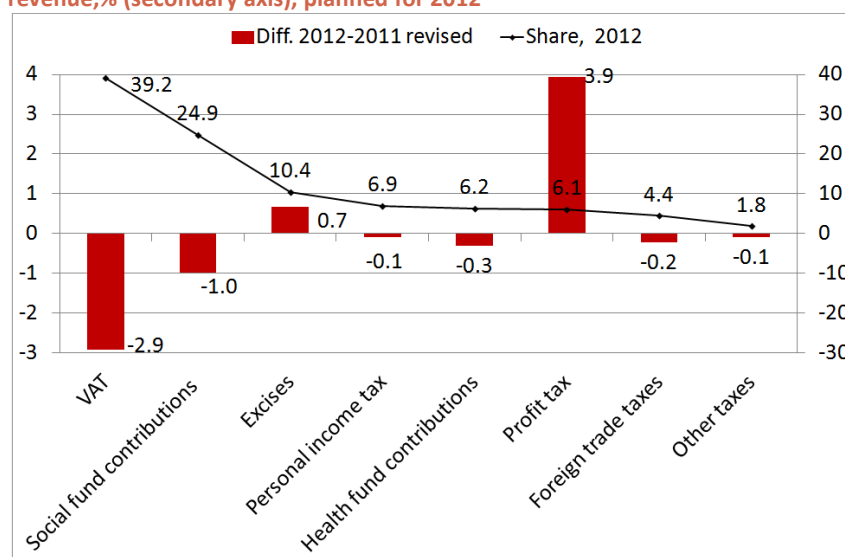
## 12. Budgetary Policy

### Strengths and weaknesses of the budgetary-fiscal policy

After receiving the "blessing" of the IMF, the draft budget law finally reached the Parliament (on 27.11.11). Submission of the draft to the Parliament with a delay of almost two months is unacceptable, even if it can be justified by objective reasons. In general, the failure of the Government or another institution to comply with the law tarnishes its authority and respect for it. Moreover, the delay in budget approval impacts significantly its implementation. The lack of efficiency on behalf of the Parliament is also worrisome, as we risk starting 2012 without an approved budget.

Through the budgetary-fiscal policy and draft budget law for 2012 the Government continues to pursue consistently the goal of diminishing the budget deficit under 1% of the GDP by decreasing the current expenses and strengthening the fiscal system. As a result of the changes to the fiscal system, the share of revenue from entrepreneurial activity and excise taxes is estimated to increase, while the other tax revenue will have lower shares (Chart 22). Thus, the revenue from entrepreneurial activity will exceed the revenue from foreign activity. These changes are expected mainly due to the introduction of the corporate income tax of 12%. At the same time, the draft budget reveals that the share of tax revenue in the GDP will not increase, but drop by 0.1 p.p. reaching 31.3%.

**Chart 22. Changes in the structure of tax revenue of the NPB, p.p. (main axis) and the share in total fiscal revenue,% (secondary axis), planned for 2012**



Source: Ministry of Finance and EXPERT-GRUP calculations;

Thus, the fiscal burden was redistributed from consumption to the income of business entities. According to the Ministry of Finance<sup>25</sup>, the relative diminution of the growth of VAT receipts is explained by the "increase in the taxable deliveries for exports, increase in the ration of the taxable deliveries with a lower VAT rate to the taxable deliveries with a standard rate," increase of imports in free economic zones and other transactions that are not subject to VAT, as well as some changes to the tax legislation on VAT deduction and reimbursement. The revenue of Mandatory Health Insurance Fund, Social State Insurance Fund and individuals' income tax decreased their relative

<sup>25</sup> Informative note to the draft budget law for 2012.

growth mainly as a result of the decrease in the share of payroll fund in the GDP. The revenue from foreign activities also registered a lower growth due to the quicker increase of exports over imports.

Though the introduction of the corporate income tax of 12% cannot be regarded as a reform per se, it is an important move to balance the sources of revenue and strengthen the fiscal base of local budgets. This will also lead to a more equitable taxation, which will reflect more appropriately the use of resources and conditions provided by the society to taxpayers for earning revenues.

At the same time, the level of taxes is important to attract investments and promote economic growth. But, zero-base corporate income tax does not necessarily guarantee a flourishing economy, the issue is rather to find an optimal taxation level. We believe that the rate of 12% in the current conditions of the Republic of Moldova is acceptable, but not optimal. This statement is based on the fact that in the Republic of Moldova currently the general taxation level of business entities is much lower than the average level in the region and only Bulgaria of the close neighbors has a lower level. Besides, based on the information published by the Government, we can conclude that the tax rate was set taking into account the budgetary policies rather than clearly determined objectives on the taxation of business entities. In other words, there isn't any explicit justification of the 12% rate, covering all its elements and implications on the budget revenues vs. the change of the overall business environment, investment attractiveness, support of small and medium-size enterprises and starting up new businesses.

Also, it is not justified to tax the dividends that are in form of shares and do not change the participation quotas of shareholder in the authorized capital. This will hinder the rise in capital. The 15% rate is not well justified either, and could demotivate investors.

Another objection refers to the taxation of non-payers of VAT (business entities with taxable revenue under MDL 600 thousand) with 4% of the operational revenue aiming to simplify the accounting and fiscal management of these taxpayers. In our opinion it is not fair and it can be applied only to the small entrepreneurs involved in retail trade or services rendered to the population.

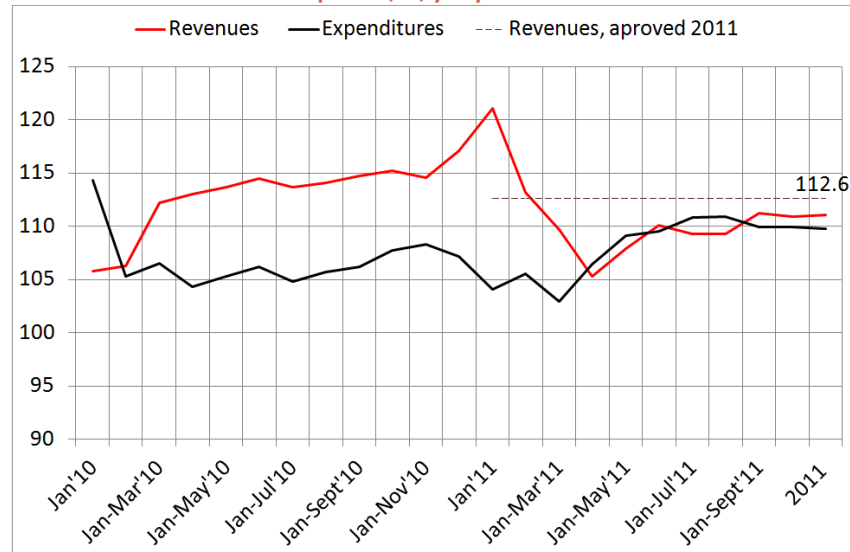
In addition, given the current situation of a large number of agricultural farms and individual enterprises, their taxation as individuals (at the rate of 18% for revenue over MDL 25200) disadvantages them in comparison with business legal entities in terms of business development. At the same time, the use of this form of entrepreneurial activity is more advantageous for the entrepreneur if the funds are withdrawn from the business.

Personal income taxation is another area that needs a redesign. In the draft law for 2012 it remained in the previous parameters, with an inflation adjustment of the personal exemption. We believe that the current taxation system is too burdensome for the individuals, whose incomes are close to the cost of living level, and the inflation adjustment of the personal exemption is neither enough, nor efficient to overcome this problem.

The good evolution of the economy in Q1-Q3'11 arose positive expectations that the increase of the revenue of the national public budget (NPB) will reach the initially planned level of 12.6% y-o-y for 2011. But this did not happen. Thus, because the NPB revenue in Q1-Q3'11 were 1.3% lower than the planned revenues (Chart 23), the Government amended the state budget law by decreasing the NPB revenue and expenses by about MDL 412.8 million<sup>26</sup>.

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<sup>26</sup> Law no. 224 of 25.11.2011 to amend the State Budget Law for 2011 no. 52 of 31 March 2011. Informative note to this law.

**Chart 23. NPB revenue and expenses, %, y-o-y**

Note: For 2011 rectified;

Source: Ministry of Finance and EXPERT-GRUP calculations;

Thus, the Government is unshaken in its intention to execute the NPB for 2011 with a budget deficit up to 1.9% of GDP. The growth parameters, amended for the 2011 NPB are 11.1% y-o-y for revenue and 9.8% y-o-y for expenses instead of the initially approved 12.6% and 11.2%, respectively. At the same time, taking into account the experience of the previous years on expenditure execution, the deficit might be even lower.

## Forecast

- The NPB revenues are expected to increase up to 11% y-o-y, and the expenditures to be executed under the level of 9.7%. A slight decrease of the revenue growth rate is expected for the next year, up to 10.1% if compared with the level approved for 2011 and about 7.5% for expenses. But these forecasts do not take into account the impact of a possible crisis in the EU;
- There are no signs that the goal to attain a deficit of 1.9% of the GDP will not be reached in 2011. It is even possible to have better results if the expenditures' execution will be tardy. The recent economic developments in the region put at risk the possibility to achieve the objective of 0.9% of the budget deficit for the next year. Our forecast of the deficit is slightly higher - 1.1% of the GDP.

## Policy recommendations

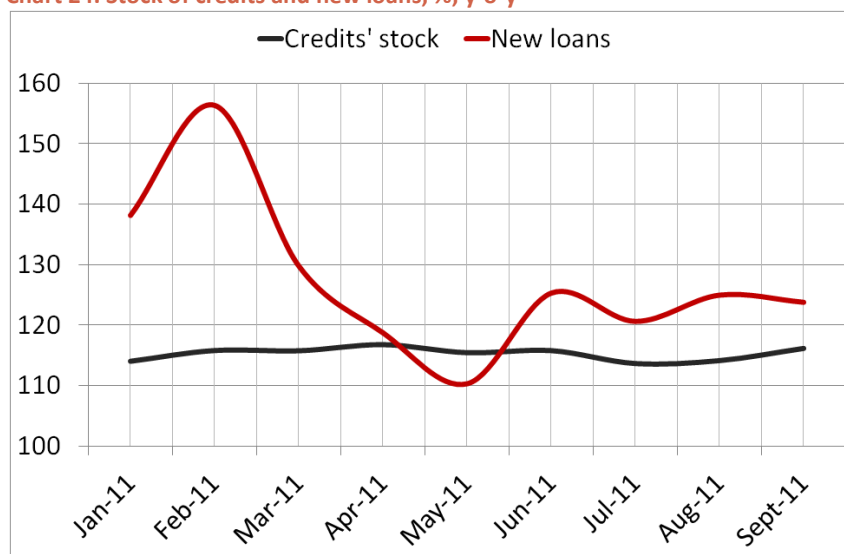
- The current fiscal system had plenty of flaws and needs a reengineering. Its quality and stability impact the economic development and budget stability. To decrease the annual interventions in the taxation system it is necessary to develop a new fiscal system for a 3-5 year period, separated from the annual budgetary process;
- Development of any budgetary-fiscal policies should start with the approval of some well-defined objectives by the governance. The experience shows us that the budgetary-fiscal policies were developed without taking into account clear and expressly stipulated goals related to the general taxation level by categories of taxpayers, social protection and other fundamental parameters. In their absence, the political approval process risks to stir objections from parliamentary political forces, making their implementation impossible without some conceptual changes in the drafts.

### 13. Financial Sector

#### Maturing credit growth, lower credit costs and cleaner balance sheets: signs of full recovery?

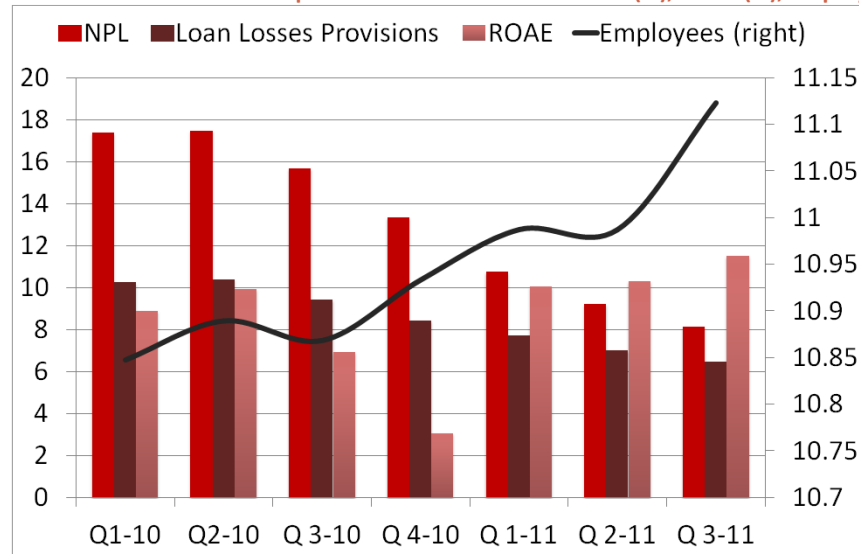
Over the second half of 2011, the credit expansion remained ample owing to continuous economic recovery and credit costs dipping to new historic lows: at the end of October the nominal lending rate decreased by about 1.2 p.p. to 14.03%, while in real terms – by 3.4 p.p. from the beginning of the year. This trend was correspondingly reflected by international rankings. Thus, according to the last issue of Global Competitiveness Report 2011-2012, Moldova climbed 10 positions and ranked 109 out of 142 countries according to the ease of access to loans. Additionally, the credit cost became the 3<sup>rd</sup> most problematic issue for doing business, while in the previous edition it was 2<sup>nd</sup>. Although this issue remains one of the most critical constraints to growth for the Moldovan economy, there is a clear positive trend over the last years. As a result, the amount of new loans posted a 28% y-o-y average growth over the same period of time. As it approached the growth rate of credit stock, the credit expansion entered into a maturing phase. Still it remained at a relatively healthy level, since banks try to channel their idle liquidities into the real sector and to decrease the opportunity costs of holding money (Chart 24).

Chart 24. Stock of credits and new loans, %, y-o-y



Source: NBM and EXPERT-GRUP calculations;

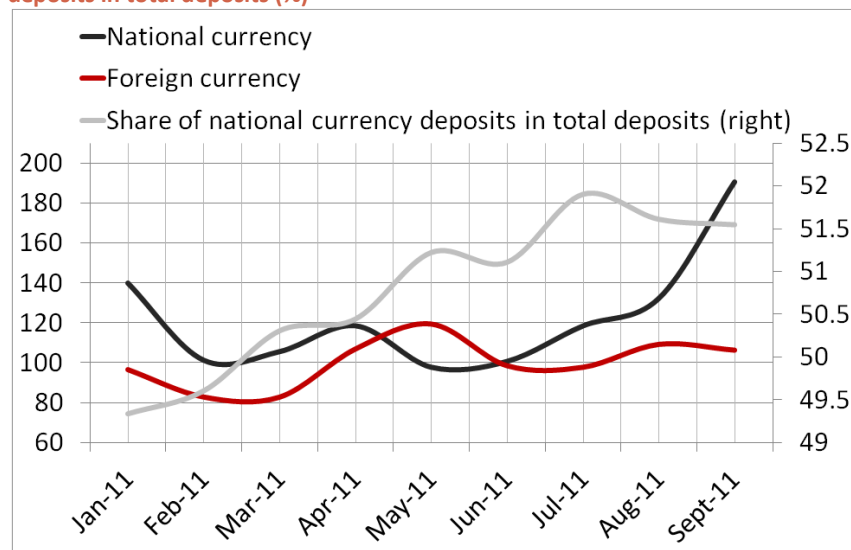
Credit expansion boosted the profitability levels of commercial banks and filtered out significant amounts of non-performing loans (NPL) from their balance sheets. Thus, at the end of the Q3'11, the NPL share in banks' portfolios was almost twice as low as in the same period of the previous year, while the returns on equity doubled. However, the banks did not reduce their loan loss provisions at the same pace, which speaks about the fact that the NPL structure remained very burdensome. Particularly, this is related to several problematic banks which are closely monitored by the NBM. Additionally, during the same period, the number of people employed by commercial banks increased by 2.3% (Chart 25).

**Chart 25. NPL and loan loss provisions' share in total credits (%), ROAE (%), employees (thousands)**

Source: NBM;

Despite these positive trends, the overall banking industry has not fully recovered after the recent economic crisis. Hence, NPL share in total credits remained more than half higher than at the end of 2008, while the profitability level – almost half lower. It points out the critical amount of “toxic assets” held by some commercial banks, as well as the deficiencies of insolvency legislation and judicial system which make the process of writing off bad loans very time consuming.

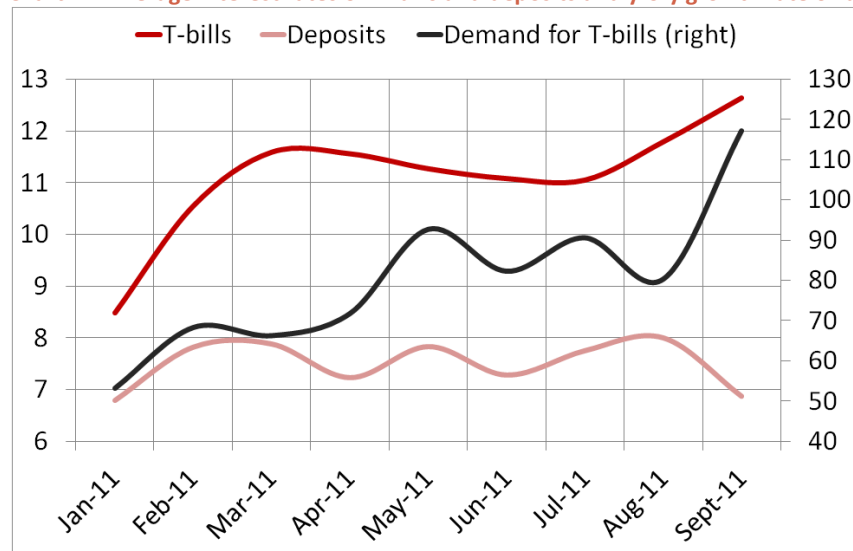
Higher population's disposable income and firms' turnovers boosted the deposits stock which during January-September 2011 grew on average by 15.8% y-o-y, being propelled by national currency-denominated deposits. Thus, the constant appreciation of the MDL coupled with much lower interest rates on foreign currency deposits and high uncertainty surrounding the external environment, decreased the dollarization level of banking deposits (Chart 26). This bodes well for increasing the efficiency of central bank's transmission channels and decreasing the interest rates risks for commercial banks.

**Chart 26. National and foreign currency denominated deposits (% y-o-y), and share of national currency deposits in total deposits (%)**

Source: NBM and EXPERT-GRUP calculations;

Banks enjoyed such a strong inflow of deposits while keeping constant their interest rates which was an additional factor greasing their profitability levels. Partially, it is a plausible reflection of how thin the domestic financial market is, as the narrow range of savings instruments left households and firms with only few feasible alternatives to banking deposits. Moreover, the popularity of these alternatives is undermined even by the lack of information. The most relevant example is the T-bills which during the last 12 months are subject to striking paradox: the interest rates on T-bills, which are considered as zero-risk investment, significantly exceed the interest rates on deposits. As a result, banks exploited this discrepancy by earning profits from zero-risk investments: the demand for T-bills on the primary market in September 2011 increased by 17.2% y-o-y (Chart 27).

**Chart 27. Average interest rates on T-bills and deposits and y-o-y growth rate of banks' demand for T-bills (%)**



Source: NBM and EXPERT-GRUP calculations

An important trend registered during the current year was a strong increase in the share of long-term deposits in total deposits up to 18.1% in September 2011, which is 2.5 times more than in the same period of the previous year (7.1%). It can be explained by 2 main factors: (i) persistent political instability and high uncertainty surrounding the external economic environment determine many entrepreneurs to postpone their investment projects and, thus, to convert their liquidities into bank deposits; and (ii) the recent NBM decision to apply a preferential 0% required reserves rate on collected deposits with >2 years maturity<sup>27</sup>. Its main objective was to ensure a wider access of commercial banks to “long money” and, thus, stimulate long-term lending. Additionally, it could motivate banks to downsize the lending risk premiums as a result of lower liquidity risks. Hence, an increase in the share of long-term deposits should diminish the maturity gap between banks' liabilities and assets (traditionally, the share of long-term credits was 55%-65% while the deposits share was only about 5-7% of total deposits). So far, the impact of this decision is quite limited: in October, the share of credits with a maturity of >1 year in total credits was even lower by 3.9 p.p. than in the same period of 2010 (64.6% in comparison with 68.5%).

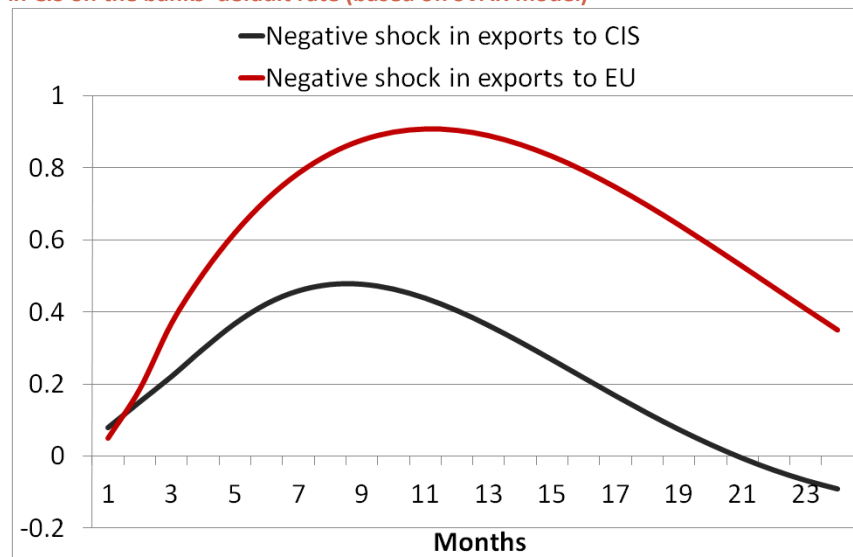
Amid weaker global growth expected for the next year and the risks of looming recession in the euro area, a particular attention should be drawn to the level of exposure of the Moldovan banking system to foreign shocks. Our estimations show that besides the decrease in remittances and the overall slowdown in economic growth, a robust transmission channel of an external crisis is the plummeting of foreign demand. Moreover, the drop in exports to EU will affect much stronger the commercial banks than a shock in exports to CIS countries. The reason is that European market-

<sup>27</sup> Decision no. 111 from 26.05.2011 regarding the modification and completion of the Regulation regarding the required reserves status



oriented companies are traditionally considered more creditworthy and, thus, are more preferred by banks. Consequently, it influenced the level of exposure of the banking system to such firms: 1 p.p. slowdown in exports to EU leads to an increase in default rate, measured as the share of NPL in total credits, by 0.9 p.p. after about 11-12 months; a similar shock in exports to CIS has a twice lower impact on the banks' default rate (Chart 28).

**Chart 28. Comparative simulated impact of a 1 p.p. slowdown in y-o-y growth in exports in EU with exports in CIS on the banks' default rate (based on SVAR model)**



Source: EXPERT-GRUP calculations;

## Forecast

- Due to high exposure to a potential crisis in EU, the profitability levels and quality of balance sheets of the Moldovan banking system will highly depend on the evolution of economic situation in this region. Thus, we should assume two scenarios: (i) in the best-case scenario, if the EU policymakers find a feasible exit from the current crisis, the Moldovan banks will continue improving their financial situation by cleaning their assets, increasing the profitability levels and further supporting a healthy credit expansion; (ii) upon realization of the worst-case scenario, the recession from EU could prompt a sharp reversal of the recovery process in the Moldovan banking system with worsening of banks' portfolio quality and plummeting supply of credits due to higher risk aversion;
- Moldovan banks are relatively immune to the foreign exchange risk stemming from the Eurozone's sovereign debt crisis, since the long open foreign exchange position of the banking system for Euro is by 32.9% lower than in USD (end of October 2011), the eventual. Thus, an eventual depreciation of the Euro in relation to USD will even generate some gains for commercial banks. Therefore, the main transmission channel of this crisis is likely to be by worsening the quality of banks' credit portfolios, with potential impact of profitability and liquidity levels;
- The lending rates are likely to remain at the current lows until the end of 2011. Moreover, the expected disinflation from 2012 could drive down lending costs even further. However, in case of the worsening of the economic situation in the region, the banks could increase the risk premiums which will mitigate the disinflation impact on the credit costs. In any case, there are no clear premises for the increase in lending rates over this time perspective.

## Policy recommendations

- Although the National Development Strategy Moldova 2020 stipulates several crucial issues of the Moldovan financial sector and sets, generally, the right strategic priorities, it lacks several fundamental aspects. Thus, it should be completed with other 3 strategic objectives: (i) ensuring stronger lenders' rights, given the time consuming procedure of collateral execution and poor functioning of credit history bureaus; (ii) privatization of state-owned assets from the banking system which will stimulate the competition, banking efficiency, attract more FDI and will, finally, decrease the credit costs; and (iii) ensuring the security of the banking system, both in terms of shareholders' rights and exposure to foreign risks.

## 14. Foreign Trade

### Sunny days...and clouds on the horizon

The recovery of foreign trade continued puffing along in the second half of 2011 as well. It came as little surprise that both exports and imports well exceeded the historical highs of 2008 in absolute terms. In the first three quarters of 2011 the rate of expansion was breath-taking: 56.9% for exports and 40.1% for imports, y-o-y. The most recent (Q2'11) available regional data shows strong trade expansion both in the CIS and EU: 44.8% and 26.2%, respectively<sup>28</sup>.

The expansion of exports is stronger and distributed more or less evenly between the CIS and EU, while advances on the markets of other countries remain limited. In January-September, 2011 exports to the EU increased by 62.8%, to the CIS by 60.4% and to the third countries by 'meagre' 22.3%, y-o-y. On the import side, the geographical distribution of imports is roughly even among all three directions with gains around 40%, y-o-y.

The merchandize trade expansion is also matched by advances in the services' trade. In H1'11 the growth in exports of services reached 24% and imports 20.1%, y-o-y. Moreover, in Q2'11 for the first time since the beginning of 2008 the trade in services posted a modest but positive balance (1.25 mln. USD)<sup>29</sup>.

The expansion of trade is driven by a series of factors.

- Firstly, Moldova's trade expansion is part of a wider global and regional picture as the post-crisis recovery was in full swing. This recovery trend is underpinned by both expansion of exports as response to recovering demand on foreign markets and increasing imports as economic recovery of the host economies sparked pick-up in inflows of remittances from labour migrants;
- Secondly, the low comparative base of 2010 remained quite favourable, and made trade figures to look extremely robust;
- Thirdly, there is genuine growth both in certain traditional (foodstuffs, textiles as well as communications and IT in services) and new-born sectors (machinery and equipment for specific industries);
- Fourthly, re-exports increased spectacularly by 71.4% and hold slightly less than half of total exports. The analysis of aggregate trade data suggests that the biggest volume of re-exporting takes place in metals and metal waste, petrol, power-generation and metal processing machinery and equipment.

An attentive look at these drivers points at the risk belying the trade expansion. Indeed, although it has often been assumed that high exports growth rates suggest long-awaited shift in the economic development paradigm, the situation on the ground could prove much more sober. Moreover, there are signs that the spectacular growth rate is petering out. In fact, the data for latest months (August-September) points exactly in this direction as export growth rates have started decelerating.

- Firstly, there are growing downside risks in the external environment. The euro-area is in a full-blown crisis and to get out of it the European economies will require considerable time. Since the EU is the largest world economy on the aggregate, it is clear the crisis will adversely affect economic growth in different parts of the world. The situation will be further magnified by dim economic prospects in the US and Japan;

<sup>28</sup> WTO, short-term merchandise trade statistics, November 2011.

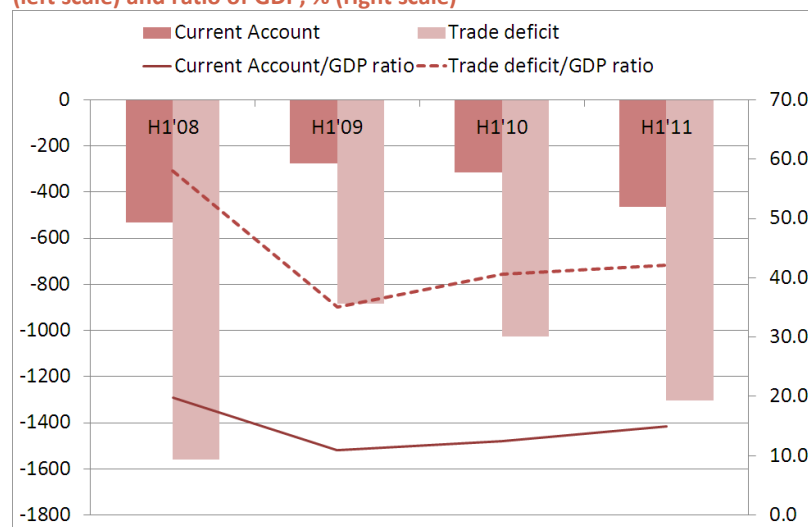
<sup>29</sup> Preliminary data, still subject to change.

- The second comes the comparison base. Closer to the end of 2011 the comparative base for a series of exports, such as metals, sugar, machinery will become less favourable and thus will mathematically undercut growth rate;
- Thirdly, the breath-taking expansion of re-exports in fact shows vulnerability of the current expansion. Indeed, as the growth in exports is supported only by much more timid advances in industrial production and stagnant labour market, it becomes clear this growth is only partly rooted in the country's economic fabric. Firstly, growth in re-exports is usually not associated with wide economic improvement (establishment of new supply chains, technology transfer and job creation). Secondly, it is much more vulnerable to whims of external demand as regional trade flows will be the first to suffer if, eventually, the second wave of crisis unfolds.

All this makes the prospects for export-led growth much bleaker than current figures suggest. Indeed, the current expansion is built on shaky foundations and if the structural change remains slow and political environment remains inauspicious, the much needed take-off will still prove elusive.

Rubbing salt into the wound, proxy data show worsening standing with respect to current account and trade deficit. After dip in 2009, the current account to GDP and trade deficit to GDP ratios have gone deeper in red and thus have casted doubt over the progress made in the development paradigm shift (Chart 29).

**Chart 29. Half-year evolution of the current account and trade (goods and services) deficit, y-o-y, illion USD (left scale) and ratio of GDP, % (right scale)**



Source: NBS, NBM, EXPERT-GRUP calculations;

## Forecast

- The downside risks ([MEGA 4](#)), will be weighing on heavier towards the end of the year. The euro-crisis is in full swing and growth prospects are very bleak. Still worse, sooner or later it will affect other regional economies as well, resulting in harsher economic environment in eastern direction as well. At the same time, 'positive' side-effects of slower growth such as lower energy prices will take time to emerge as they are subject to rigid contractual or uncompetitive arrangements;
- By the same token, the income prospects of Moldovan migrants may be affected, and, thus, domestic demand and imports may come under stress. However, the pressures in this area will eventually come later than in the case of exports affected by the slowing external

demand because of the counter-cyclical nature of remittances and low elasticity of labour demand in sectors of migrants' employment;

- On the trade-related structural reforms front, and most of all from the Euro-integrations perspective, the progress has been moderate (see more in Euromonitor 21). There is significant room for improvement both on the institutional capacity, regulatory environment and practical implementation (quality infrastructure, SPS) dimensions. Heightening political instability will impede the acceleration of much needed progress on this account;
- Furthermore, one of the unintended consequences of the euro-crisis might be a much feebler ability and, indeed, desire on behalf of the EU and its core member states to pursue and finance integrationist initiatives in the neighbourhood. Such a development will put an increased pressure on Moldova to start delivering on its DCFTA-related commitments.

### Policy recommendations

- The story of SPS implementation in Moldova dates back to mid-2000's and in the meantime this issue has become a litmus test for seriousness of the euro-integration intentions of the Government in the economic field. The progress up-to-date was patchy although the high value added agriculture (and IT) are considered critical for future export-led growth. Therefore, from trade perspective the Government should really concentrate and make reform in such sector central to its activity;
- Furthermore, as DCFTA negotiations launch date may be approaching fast, the dialogue with the most important and affected sectors should be strengthened. There are persisting signs that such dialog is often missing, either due to passivity of the private sector, or because of lacking capacity/political will on the Government's side to tackle certain thorny issues related to the DCFTA;
- Given the undergoing shifts in centres of economic gravity the Government might have to deal with increasing pressure to amend its trade policy. Although this can be a distant possibility, the Government should entrench public support for economic integration with the EU by better explaining opportunities and risks to the public, and fostering reform process in the areas of most benefit to ordinary citizens, Common Aviation Space being good step in this direction. As 'side-effect' this will help uprooting vested interests, which can be seen as a boon itself.

## 15. Global Markets

### On the brink of new recession

#### Global economy: a need for reset...

The global economic outlook has dimmed significantly during last 6 months. A series of negative tendencies, mostly within advanced economies, have been scaling up recently, making gloomy forecasts about 'perfect storm' ominously possible<sup>30</sup>. Indeed, across much of the developed economies the situation is grim. Japan is grappling with high public debt and need for reconstruction efforts in afflicted areas. In the US recovery remained tepid, with persistent slack on the housing and labour market leading to weak private demand. At the same time need for fiscal consolidation has so far balked at the political stalemate.

The outlook is, however, is by far the grimmest in Europe. With most of peripheral economies on their knees because of unsustainable sovereign debt, the banking sector looking further infested with 'lack of liquidity' malaise and political class indecisive, at best, the questions are arise about viability of the euro-zone in particular and the European political project in general. Not to forget, all this is occurring against the backdrop of persisting global economic imbalances: major growing (and predominantly emerging) economies should rely more on domestic demand (i.e. should save less, spend more, and in certain cases allow their currencies to appreciate), while many stagnating (predominantly advanced) economies should save more, recapture their competitiveness and pay their debts. In the case of European economies the task is specifically daunting. It is not only about repairing public and private financial system, it is also about recovering competitive edge in a new globalized economy, it is about revising societies' social contract, facing up demographic challenge and breathing trust back into the European project as a whole<sup>31</sup>.

Given the scale of both EU's economy and risks it faces together with other advanced economies, it is clear that this protracted crisis will have vast ramifications not only for the region, but for the entire global economy. Therefore, expansion of the emerging economies will also be dented. Latest forecast reflect these developments and gloomy mood throughout much of the global economy. Thus, the IMF revised down its forecasts for global economic growth to 4% for both 2011 and 2012 (Table 4). The OECD growth forecasts are even bleaker: 3.8% and 3.4% for 2011 and 2012, respectively<sup>32</sup>.

**Table 4. Selected World Economic Outlook projections, % change, y-o-y**

Economic grouping / Geographic area	2010	2011	2012
<b>World output</b>	5.1	4.0	4.0
<b>Advanced Economies</b>	3.0	1.6	1.9
<i>United States</i>	2.9	1.5	1.8
<i>Euro area</i>	1.8	1.6	1.1
<i>Germany</i>	3.5	2.7	1.3
<i>Italy</i>	1.3	0.6	0.3
<b>Emerging and developing economies</b>	7.4	6.4	6.1
<i>Central and Eastern Europe</i>	4.5	4.3	2.7
<i>Romania</i>	-1.3	1.5	3.5
<i>Poland</i>	3.8	3.8	3.0
<i>CIS</i>	4.6	4.6	4.4
<i>Russia</i>	4.0	4.3	4.1

<sup>30</sup> See "Roubini says 'Perfect Storm' May Threaten Global Economy", Bloomberg June 13, 2011, <http://www.bloomberg.com/news/2011-06-11/china-economy-at-risk-of-hard-landing-after-2013-nouriel-roubini-says.html>.

<sup>31</sup> The Economist, "Starring into abyss. Special report on the future of Europe, November 12-18, 2011; Uri Dadush, "Five great misconceptions about the euro crisis", National Interest, November 10, 2011, available at: <http://carnegieendowment.org/2011/11/10/five-great-misconceptions-about-euro-crisis/71ee>

<sup>32</sup> OECD, Economic Outlook, November 2011.

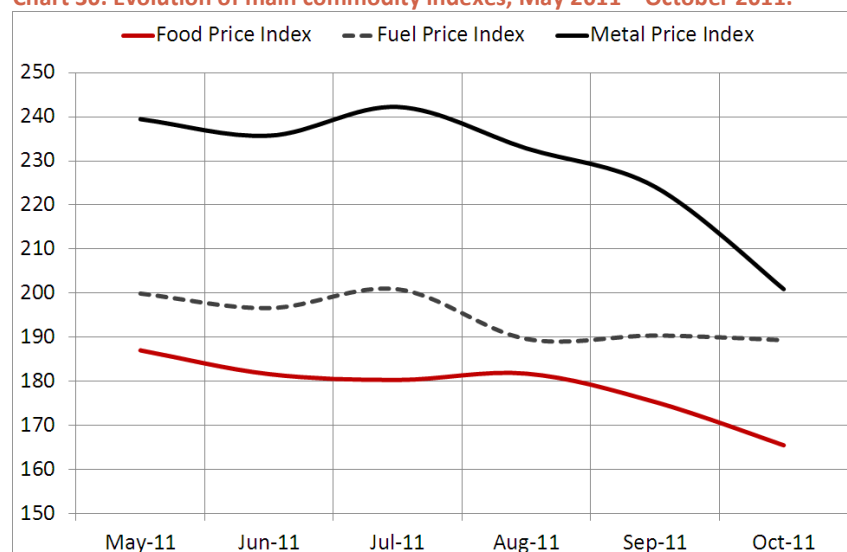
<b>Ukraine</b>	4.2	4.5	4.9
<b>Developing Asia</b>	9.6	8.2	8.0

Source: WEO, September 2011, IMF;

### Commodity markets: a volatile recovery

The prices for main commodities remained highly volatile. However, downwards trend was obvious as bleaker global economic outlook squeezed investors' risk appetite as well as expectations for future demand. This tendency was characteristic for pretty much all commodities, but most of all for food and oil, where the previous price rally was the most salient. On the food front, the trend is also supported by generally positive expectation for future harvest. On the oil market, forecast global oil demand is revised down by 70 kb/d for 2011 and by 20 kb/d for 2012, with lower-than-expected 3Q11 readings in the US, China and Japan<sup>33</sup>. Although posting slightly diminished values, prices for commodities are still pretty high from historical perspective (Chart 30). For instance, the oil (Brent) was testing in the beginning of December 2011 the \$110 mark, which is among historically highest levels. All this means that small resource-poor economies, like Moldova, are still to grapple with the consequences and design its development plans taking into consideration such resource constraints.

**Chart 30. Evolution of main commodity indexes, May 2011 – October 2011.**



**Description:** Commodity Metals Price Index includes Copper, Aluminium, Iron Ore, Tin, Nickel, Zinc, Lead, and Uranium Price Indices; Commodity Fuel (energy) Index includes Crude oil (petroleum), Natural Gas, and Coal Price Indices; Commodity Food Price Index includes Cereals, Vegetable Oils, Meat, Seafood, Sugar, Bananas, and Oranges Price Indices; 2005 = 100;

Source: IMF;

### Forecast

- The global economic outlook will remain dim in the short-term perspective. Indeed, an outright recession in much of the euro-zone economy is on cards. Clearly, the austerity measures that have been and will be implemented in the most of advanced economies will put downward pressure on demand and as such the global economy will need to look for other engines for growth. Indeed, the global trade growth is forecasted to slow down to 4.8% from 6.7% anticipated in 2011<sup>34</sup>;
- Furthermore, shedding debt burden might take some time, meaning slowdown of the economic growth not only in the advanced economies, but to a certain extent in the emerging ones as well. The economic slowdown or even downturn may further challenge the

<sup>33</sup> IEA, Oil market report, November 2011.

<sup>34</sup> OECD, op. cit.

existing social and political underpinnings leading to shifts in the political discourse and architecture as well as revision of social contracts in many countries. Such challenges will not be limited only to advanced economies, but also to emerging ones since their social peace depends so much on the high rates of economic growth;

- The sovereign debt crisis in Europe may have further ramifications for the EU's geopolitical stance in the region. Escaping the current 'high debt – low competitiveness' trap will necessitate changes in the European institutional arrangements, geopolitical rebalancing of roles among member states, and, alas, social pain. All this can make European policy more introvert, leaving much less resources, will and public support (which is already low) for modernizing the European neighbourhood;
- The global economic slowdown will eventually lower demand and prices for commodities affecting thus growth and, perhaps, social stability of certain commodity exporting countries. This is not necessarily good news for Moldova, as lower demand for fuel or metals will be accompanied by lower demand for Moldovan exports and, alas, re-exports (among which petrol and metals play an important role).

### Policy recommendations

- In the forthcoming period Moldovan government will clearly need not a plan B, but several plans B;
- One of them will be related to the development policy, as the shift towards export-led and investment-based growth will have to take place amidst adverse external environment. It will only magnify Moldova's political and reform policy frailties, which Moldova failed to solve more benign circumstances. If this both are resolved, becoming an innovative nation will be a key;
- European aspirations are crucial for Moldova's modernization plans. If the European neighbourhood policy becomes more introvert, the current substance behind "success story" will not be enough for Moldova. Such a reality would require a shift both in policy thinking and in practice;
- Furthermore, it will become increasingly difficult for Moldovan authorities 'to sell' European dream to Moldovan populace. With many important reforms unimplemented, the Government risks entering this difficult period empty-handed;
- Finally, the Government will need resources to support vulnerable population and maintain social peace in the country if things turn totally nasty on regional level and no considerable external support will be forthcoming. There is a clear need in 'rainy day' resources.



## About the Expert-Grup

### Who we are

EXPERT-GRUP is a leading economic think-tank in Republic of Moldova. It is member of the PASOS (Policy Association for an Open Society) network comprising 39 policy think-tanks in 27 countries from Central and Eastern Europe and Central Asia.

### Our mission

The institutional mission of the Expert-Grup is to contribute to the economic, democratic and social development of Republic of Moldova, as well as to promote its international competitiveness. We tend to accomplish this mission by delivering top quality services and promoting efficient, transparent and innovative policy models.

### Main activities

- Provide the public with relevant and most up-to-date analysis on economic trends;
- Offer assistance and consultancy in the decision-making and policy-making processes;
- Promote innovative development solutions and policy models.

### Areas of expertise

- Development strategies;
- Macroeconomics and economic systems;
- Global economy and international economic relations;
- Economy of the European integration;
- Monetary and fiscal policies;
- Labour economy, management and business culture;
- Consumer behaviour;
- Industrial and agricultural economics;
- Economy of health and education.

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